

“Taking the Success Out of Successor Liability”

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I. Scope Note

When a debtor files for bankruptcy, it is often because numerous creditors are asserting competing interests in whatever assets the debtor may have. A debtor may have pledged its inventory and manufacturing equipment as collateral for an operating loan from the bank. The same manufacturing equipment may be encumbered by a purchase money security interest from the equipment vendor. The landlord may also have taken a blanket lien on the debtor’s assets as security for the lease. When the debtor files for Chapter 11 bankruptcy protection, the bank, the equipment vendor and the landlord will each claim an interest in the debtor’s property. At the same time, general unsecured creditors will seek to have their claims satisfied out of the same pool of assets.

With its property significantly encumbered, the debtor would find it difficult, if not impossible, to sell its business as a going concern outside of bankruptcy. However, a bankruptcy court has the power in certain circumstances to order a sale of some or all of the debtor’s assets free and clear of competing creditor interests, without the consent of the parties asserting these interests. The scope of the bankruptcy court’s power to enter such “free and clear” orders and the amount of additional protection that these orders provide against successor liability exposure, remains subject to heated debate. As one court has noted, “the entire issue of successor liability...is dreadfully tangled, reflecting the difficulty of striking the right balance between the competing interests at stake.”¹

Whether you are representing the debtor who is selling all or substantially all of its assets, the purchaser of these assets, or a third party with claims against the debtor at the time of the sale or at some future time, you will need to review carefully each of the following in order to evaluate the impact of the sales transaction on issues of successor liability:

- a. state law;
- b. federal common law;
- c. section 363(f) of the Bankruptcy Code; and
- d. section 1141(c) of the Bankruptcy Code.

Of course, you will also need to analyze the specifics of the transaction itself, the nature of the business and the composition of the parties. While no clear-cut answers will be derived at the

¹ *EEOC v. Vucitech*, 842 F.2d 936, 944 (7th Cir. 1988).

conclusion of this exercise, you will be better equipped to represent your client's interests in this legal morass.

In the sections that follow, we discuss each of the aforementioned bodies of law that affect the extent to which a purchaser of assets may be subject to successor liability claims. In the concluding section, we offer practical tips to assist the purchaser of assets in minimizing its exposure to such claims, with the understanding that such exposure can rarely, if ever, be entirely eliminated.

II. Successor Liability Under State Law

It is black-letter law in virtually all jurisdictions that when the buyer – call it Company B -- buys all, or substantially all, of the assets of the seller – call it Company A, Company B does not thereby become liable for the debts or liabilities of Company A.

However, there are several well-established exceptions to the general rule. Most jurisdictions recognize four such exceptions:

1. When there is an express or implied agreement by Company B to assume the debts or liabilities of Company A;
2. When the transaction amounts to a *de facto* merger of the two companies;
3. When Company B is a mere continuation of Company A; and
4. When the transfer of assets was done for the purpose of defrauding the creditors of Company A.

Some courts have identified inadequate consideration or lack of good faith as a fifth exception, although many courts treat these as merely factors to consider in determining whether one of the other exceptions, most notably No. 4, the fraud exception, exists. *See Kemos, Inc. v. Bader*, 545 F.2d 913 (5th Cir. 1977); *Cyr v. B. Offen & Co., Inc.*, 501 F.2d 1145 (1st Cir. 1974).

Some courts have identified inadequate consideration or lack of good faith as a fifth exception.²

A. Assumption of Liability

Company B will become liable for the debts of Company A to the extent that it agrees to assume Company A's liabilities. In the typical sales transaction, the asset purchase agreement will include provisions that set forth in detail which of Company A's liabilities are being assumed. In certain cases, courts have looked beyond the express language of which liabilities

² *See, e.g., Fuisz v. Lynch*, 147 Fed. Appx. 319, 2005 U.S. App. Lexis 14795 (4th Cir. July 20, 2005), where the court found that the mere continuation exception was satisfied under Virginia law because the sale of assets did not constitute a *bona fide*, arms-length transaction.

Company B has agreed to assume and have found an implied assumption of certain other liabilities. *See Luxliner P.L. Export, Co. v. RDI/Luxliner, Inc.*, 13 F.3d 69 (3d Cir. 1993); *Kessinger v. Grefco, Inc.*, 875 F.2d 153 (7th Cir. 1989), *reh'g denied*, 1989 U.S. App. LEXIS 11712 (7th Cir. July 19, 1989); *Dayton v. Peck, Stow & Wilcox Co.*, 739 F.2d 690, 692 (1st Cir. 1984). For example, in *City of Richmond, Va. v. Madison Mgmt. Group, Inc.*, 918 F.2d 438 (4th Cir. 1990), the Fourth Circuit upheld a jury verdict in which voluntary actions taken by an asset purchaser were found to constitute an implied assumption of liabilities under an asset purchase agreement. Thus, it is good practice to specify not only which liabilities are being assumed, but also which liabilities are not being assumed.³

B. De Facto Merger

The *de facto* merger exception typically involves transactions that are couched as the sale of assets, but which contain elements more characteristic of a merger or consolidation of Company A into Company B. The circumstances that are likely to lead to a finding of a *de facto* merger are the following:

1. a continuation of the enterprise of Company A in the form of continuity of management, personnel, physical location, assets and general business operations;
2. a continuity of shareholders as a result of Company B purchasing the assets of Company A with shares of Company B stock that are issued to the shareholders of Company A;
3. shortly after the sale, Company A ceases its ordinary business operations and formally dissolves; and
4. Company B takes over those obligations of Company A that are necessary for the uninterrupted continuation of Company A's normal business operations.

These four requirements were identified by the Eleventh Circuit in *Bud Antle, Inc. v. E. Foods, Inc.*, 758 F.2d 1451, 1456 (11th Cir. 1985), cited with approval by the North Carolina Court of Appeals in the seminal successor liability case *Budd Tire Corp. v. Pierce Tire Co., Inc.*, 370 S.E.2d 267, 90 N. C. App. 684 (N.C. App. 1988), discussed below. *See also Arnold Graphics Indus. v. Indep. Agent Ctr., Inc.*, 775 F.2d 38, 42 (2d Cir. 1985); *Philadelphia Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 310 (3rd Cir. 1985); *Dayton*, 739 F.2d at 693; *Keller v. Clark Equip. Co.*, 715 F.2d 1280, 1291 (8th Cir. 1983).

For this exception to be applicable, all four elements need to be present. However, there have been a few decisions in other jurisdictions where the second element – continuity of

³ The defendant learned this lesson the hard way in *Park v. Alcon Surgical, Inc.*, 991 F.2d 790 (4th Cir. 1992), when it was found to have assumed liability under a contract that was not specifically identified in the asset purchase agreement. The Court found that the parties had chosen not to identify each and every contract being assumed, such that the contract in question could have been subject to assumption even though it was not specifically identified.

ownership – was not present and the court nevertheless applied successor liability to the asset purchaser under a theory of *de facto* merger. See, e.g., *Cytec Indus., Inc. v. B.F. Goodrich Co.*, 196 F. Supp. 2d 644, 658 (S.D. Ohio 2002); *Diaz v. South Bend Lathe Inc.*, 707 F. Supp. 97 (E.D.N.Y. 1989); *Turner v. Bituminous Cas. Co.*, 244 N.W.2d 873 (Mich. 1976); *Woodrick v. Jack J. Burke Real Estate, Inc.*, 703 A.2d 306, 312 (N.J. Super. Ct. App. Div. 1997), *cert. granted sub nom. Woodrick v. Fox & Lazo, Inc.*, 708 A.2d 65 (N.J. 1998), *appeal dismissed*, 724 A.2d 799 (N.J. 1998).

Along the same lines, the *de facto* merger exception has been applied in the absence of the third element -- dissolution of the seller company. Such was the case in *Greater Potater Harbor Place, Inc. v. Jenkins*, 935 F.2d 267 (4th Cir. 1991) (unpublished disposition). Just after the U.S. District Court in Maryland found in favor of Jenkins in a trademark infringement case against the owner of Thrasher's, Inc., Thrasher's sold substantially all of its assets to Greater Potater and related corporations. It was shown that Thrasher's and Greater Potater had the same owners, officers and managers, leased the same office space, continued the same operations and used the same equipment and many of the same business practices. The defendant argued, however, that because Thrasher's continued to exist after the sales transaction, a *de facto* merger could not be established. The Court rejected this argument, holding that "[t]here should be liability imposed [under a *de facto* merger theory] even when the predecessor corporation has not been terminated, since one should not be able to escape liability with such a convenient artifice." *Id.*, citing *Arnold Graphics Indus.* at 42.

C. Mere Continuation

An example of Company B being a "mere continuation" of Company A is *Dublin v. UCR, Inc.*, 444 S.E. 2d 455, 115 N.C. App. 209 (N.C. App. 1994). A class action was brought against defendants UCR and U-Can Rent I alleging that contracts entered into between the class members and the defendants constituted unfair or deceptive trade practices. During the pendency of the action, based on a default by UCR to Chrysler First Commercial Credit Corp. ("Chrysler"), Chrysler took possession of all of UCR's assets pursuant to a transfer in lieu of foreclosure and simultaneously transferred the assets to U-Can Rent II. Although the agreement expressly provided that U-Can Rent II was assuming none of the existing liabilities for actions complained of in the class action complaint, the new Company B conducted business in the same store with the same employees, equipment and forms as the old company. Under these circumstances, the court had little difficulty authorizing the class action to proceed against U-Can Rent II on the grounds that it was a mere continuation of the defendants. "To hold otherwise would sanction the transfer of assets from a corporation defending against a class action to a newly formed corporation, making the original corporation judgment proof, and allow the new corporation to escape from the claims of the class." *Id.* at 463.

Dublin v. UCR dealt with a transfer in lieu of foreclosure. Even if the transfer had been accomplished pursuant to a UCC foreclosure in accordance with 9-504, this would not stand as a *per se* bar to a claim of successor liability based on a theory of "mere continuation" of the business. As the court in *G.P. Publ'ns. v. Quebecor Printing-St. Paul, Inc.*, 481 S.E. 2d 674, 125 N.C. App. 424 (N.C. App. 1997) explained, "[N]either the drafters of the UCC nor the state legislatures which enacted comparable provisions intended to elevate form over substance by

providing an absolute bar against successor liability following a 9-504 sale where the new corporation is a mere continuation of the original debtor.” *Id.* at 680. *See also, Ed Peters Jewelry Co. v. C & J Jewelry Co.*, 124 F.3d 252 (1st Cir. 1997); *Miller v. Forge Mench P’ship*, 2005 WL 267551 (S.D.N.Y. Feb. 2, 2005).

The *G.P. Publications* decision is also instructive with respect to the scope of the “mere continuation” exception as it has evolved in North Carolina, as opposed to other jurisdictions. North Carolina follows the traditional approach to the mere continuation theory in that it requires identity of stockholders and directors between Company B and Company A. Essentially, there needs to be a showing that the same people own both companies. *Id.*⁴ The only other factors are inadequacy of consideration and lack of some of the elements that would make Company B a good faith purchaser for value.

In contrast to this traditional approach, some jurisdictions apply what has been described as a “substantial continuity” test, which goes beyond the identity of the stockholders and directors of Company B and Company A and also considers (a) retention of the same employees, (b) retention of the same management, (c) retention of the same facilities, (d) production of the same product, (e) retention of the same name, (f) retention of the same business operations, and (g) whether Company B holds itself out as a continuation of Company A. The court in *G.P. Publications* found that the court below had erred when it instructed the jury that it could consider the various factors relevant under the “substantial continuity” test, rather than limit itself to the factors relating to ownership pursuant to the traditional application of the “mere continuation” test.⁵

However, the North Carolina Court of Appeals appeared more willing to adopt the substantial continuity exception when it confronted the facts that were present in *L.J. Best Furniture Distrib., Inc. v. Capital Delivery Serv., Inc.*, 432 S.E.2d 437, 111 N.C. App. 405 (N.C. App. 1993). There, a suit was brought by a furniture retailer against a delivery service for breach of contract and negligence in connection with certain damaged goods. After the cause of action arose, the defendant ceased operations, after which two of the defendant’s key employees, together with the wife of one of the defendant’s shareholders, formed a new corporation, Duncan Transportation, Inc. Duncan purchased the assets of Capital, and, when suit was filed, both Duncan and Capital were named as defendants.

Summary judgment was granted by the trial court in favor of the plaintiff, despite the fact that there was no continuity of ownership, although there was at least some relationship to the shareholders of Capital. The Court, in all likelihood, gave significant weight to the fact that Duncan took over the same truck leases, serviced some of the same customers, had the same employees, and may never have paid the full purchase price for the acquisition of the business.

⁴ The law of Virginia is in accord. *See Ney v. Landmark Educ. Corp.*, 16 F.3d 410 (4th Cir. 1993) (unpublished disposition). Furthermore, the existence of an employment contract between Company A’s sole shareholder and Company B is not enough to establish continuity of ownership. *See, e.g., Acme Boot Co. v. Tony Lama Interstate Retail Stores, Inc.*, 929 F.2d 691 (4th Cir. 1991) (unpublished disposition).

⁵ This, of course, raises the issue of whether the court in *Dublin v. UCR* was improperly applying the broader test, since it focused on the continuation of the business operations and made no specific findings with respect to ownership.

The Court of Appeals reversed the grant of summary judgment in favor of the plaintiff and remanded the matter for further findings relative to the various factors that had been relied upon by the trial court to show that Duncan was a mere continuation of Capital. What is significant, however, is that these factors all relate to the continuation of the business operations (something more appropriately considered under the substantial continuity test) and not relevant to continuity of ownership.

Successor liability must be distinguished from principles of alter ego and piercing the corporate veil. Although the theories sometimes overlap, successor liability always involves a transfer of assets, whereas piercing the corporate veil and alter ego theories do not require a transfer. Thus, for example, in *Statesville Stained Glass, Inc. v. T.E. Lane Constr. & Supply Co., Inc.*, 430 S.E. 2d 437, 110 N.C. App. 592 (N.C. App. 1993), where an individual defendant who was the sole shareholder and sole officer of a corporation dissolved the company and then formed a new company that performed the same business and for which he was again the sole shareholder and sole officer, the Court of Appeals reversed the lower court's finding of successor liability on the simple proposition that "[i]n order to become liable as a successor corporation, there must at a minimum be a transfer of assets from the old corporation to the transferee corporation. *Id.* at 441.

D. Fraudulent Transfers

In *Budd Tire Corp. v. Pierce Tire Co., Inc.*, 370 S.E.2d 267, 90 N. C. App. 684 (N.C. App. 1988), the purchaser of a tire company was found to have purchased substantially all of the assets⁶ of the selling company for insufficient consideration, leaving the seller unable to pay its existing creditors. The Court first noted that even in the absence of actual intent to defraud, this constituted a fraudulent transfer under North Carolina law, citing, *inter alia*, *Everett v. Carolina Mortgage Co.*, 1 S.E.2d 109, 214 N.C. 778 (1939). In particular, the court was concerned that the most valuable asset of the seller was its goodwill and that this had been transferred for inadequate consideration. However, under the facts of the case, there was no basis to find an express or implied assumption of liabilities, or that there had been a *de facto* merger, or that the purchaser was a mere continuation of the seller. Instead, based solely on the lack of sufficient consideration, the court found that the seller's creditors could pursue their claims against the buyer, holding that "where one corporation purchases all or substantially all of the assets of another corporation, including the good will, in a manner deemed fraudulent, the selling corporation's creditors may follow the good will into the hands of the purchasing corporation and obtain a money damage award equal to its value." *Id.* at 271.

In *Morgan v. Cavalier Acquisition Corp.*, 432 S.E.2d 915, 111 N.C. App. 520 (N.C. App. 1993), *disc. rev. denied*, 439 S.E.2d 149, 335 N.C. 238 (1993), Cavalier Corporation, a vending machine manufacturer, was forced into involuntary bankruptcy and shortly thereafter sold its assets to a newly created corporation, Cavalier Acquisition Corporation. About a year later, a student was killed when one of the debtor's vending machines fell on him. The trial court

⁶ Although the parties claimed that the seller purchased only one-third of the assets and leased the remaining two-thirds, the trial court found that, in fact, substantially all of the assets had been sold.

granted summary judgment in favor of Cavalier Acquisition, but the Court of Appeals reversed, finding that the plaintiff had made a sufficient showing of fraud in the sales transaction to permit the successor liability claims to go to the jury.

E. Continuity of Enterprise

The “substantial continuity” or “continuity of enterprise” exception treats common ownership and control as a relevant factor but not a threshold one. This exception arises more frequently in the context of products liability litigation.

As previously noted, the continuity of enterprise exception focuses on Company B’s assumption of the business operations of Company A – continuation of the name, the employees, the location, etc. The leading case on this exception is *Turner v. Bituminous Cas. Co.*, 244 N.W.2d 873 (Mich. 1976); where the plaintiff suffered injuries while using an allegedly defective press that was manufactured by T.W. & C.B. Sheridan Company (“Sheridan”) prior to 1964. In 1964, Sheridan sold its assets for cash to a subsidiary of Harris Intertype Corporation (“Harris”). The subsidiary continued to use the Sheridan name. The plaintiff sued Harris and its subsidiary on products liability grounds, but the trial court dismissed the action since there was no continuity of ownership between the buyer and the seller, as required under both the mere continuation exception and the *de facto* merger exception.⁷ The Michigan Supreme Court expanded these exceptions in the context of products liability claims to include cases where the following four factors were present:

1. there is continuity of management, personnel, location, assets and general business operations;
2. the seller ceases its business operations and dissolves;
3. the buyer assumes the liabilities and obligations of the seller that are usually necessary for the continuation of the seller’s business operations; and
4. the seller represents itself, either expressly or by omitting to do otherwise, as the continuation of the prior business.

Under *Turner* and its progeny, if these factors are present, successor liability can be established, even in the absence of continuation of ownership and control.

F. Product Line Exception

The product line exception is, for the most part, a variation on the continuity of enterprise theme that focuses less on the buyer and seller and more on product itself, consistent with the principles of strict liability in tort. The genesis of this exception was *Ray v. Alad Corp.*, 560

⁷ The court held that the *de facto* merger exception did not apply because the assets had been purchased for cash, rather than stock in the buyer.

P.2d 3 (Cal. 1977). Under this exception, Company B may be held liable for defects in products manufactured and distributed by Company A, even if the elements of the other recognized exceptions are absent, provided the following three “justifications” for imposing successor liability are present:

1. the virtual destruction of the plaintiff’s remedies against Company A caused by Company B’s acquisition of the business;
2. Company B’s ability to assume Company A’s risk-spreading role; and
3. the fairness of requiring Company B to assume responsibility for defective products that was a burden necessarily attached to Company A’s goodwill that Company B is able to enjoy in the continued operation of the business.

Id. at 11.

III. Successor Liability Under Federal Non-Bankruptcy Law

Generally speaking, the under federal common law the successor liability exceptions seem to be interpreted more broadly. Most of the cases arise in the context of environmental and employment statutes. As one court noted, “the federal successorship doctrine is more expansive than state law....” *R.C.M. Exec. Gallery Corp. v. Rols Capital Co.*, 901 F. Supp. 630, 635 n.4 (S.D.N.Y. 1995).

A. Environmental Law Liability

The federal environmental law statutes do not directly address the issue of successor liability. As the Fourth Circuit noted in *United States v. Carolina Transformer Co.*, 978 F.2d 832 (4th Cir. 1992), the Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”), 42 U.S.C. § 9601 *et seq.* is silent as to whether successor corporations may be held liable for violations of the Act. In *Carolina Transformer*, the Court held that the national interest in the uniform enforcement of CERCLA supported the application of federal common law principles of successor liability in appropriate circumstances. *Id.* at 837. The court considered, but then rejected, the mere continuation exception and instead affirmed the district court’s application of the continuity of enterprise exception under federal environmental statutes.⁸ *Id.* at 838.

However, in *United States v. Bestfoods*, 524 U.S. 51 (1998), the U.S. Supreme Court held that the liability of a parent corporation for its subsidiary’s environmental liability must be determined under state law, not federal common law. In states that have followed the continuity of enterprise theory, this may not produce any different result, but in states such as North Carolina, where the traditional exceptions of mere continuation and fraud have not been

⁸ The Court recognized an eight-factor test adopted by the Fifth Circuit in *Mozingo v. Correct Mfg Corp.*, 752 F.2d 168, 175 (5th Cir. 1985) and a similar three-factor test referred to in *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27, 43 (1987).

substantially expanded, there may be some constriction in the exceptions to the general rule of no successor liability in asset sales.

B. Employment Law Liability

As is the case with CERCLA, there is no statutory provision for successor liability with respect to federal employment law purposes. Again, however, most courts that have considered the issue have applied some version of the continuity of enterprise exception. In *WXGI, Inc. v. Nat'l Labor Relations Bd.*, 243 F.3d 833, 844 (4th Cir. 2001), the Fourth Circuit explained that “[i]t has long been settled that the ‘purchaser of a business, who acquires and continues the business with knowledge that his predecessor has committed an unfair labor practice in the discharge of an employee, may be ordered by the [Board] to reinstate the employee with backpay,’” quoting *Golden State Bottling Co. v. NLRB*, 414 U.S. 168, 170 (1973). The Court found that the substantial continuity test utilized by the U.S. Supreme Court in *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27, 43 (1987) was the appropriate approach:

Under this approach, the Board examines a number of factors: whether the business of both employers is essentially the same; whether the employees of the new Company are doing the same jobs in the same working conditions under the same supervisors; and whether the new entity has the same production process, produces the same products, and basically has the same body of customers.

Id.

In *Braswell v. Great Expectations of Washington, Inc.*, 1997 U.S. Dist. LEXIS13600 (August 5, 1997), Judge Britt of the U.S. District Court for the Eastern District of North Carolina, Western Division, utilized the following nine-point test previously applied by the Sixth Circuit in *EEOC v. MacMillian Bloedel Containers, Inc.*, 503 F.2d 1086, 1094 (6th Cir. 1974):

(1) whether the successor corporation had notice of the charge; (2) the ability of the predecessor to provide relief; (3) whether there has been a substantial continuity of business operations; (4) whether the new employer uses the same plant; (5) whether he uses the same or substantially the same work force; (6) whether he uses the same or substantially the same supervisory personnel; (7) whether the same jobs exist under substantially the same working conditions; (8) whether he uses the same machinery, equipment, and methods of production; and (9) whether he produces the same product.⁹

IV. Successor Liability Under Bankruptcy Law

A. Policy Considerations

When Company A files for bankruptcy and thereafter seeks to sell some or all of its assets, factors come into play that would not necessarily exist outside of bankruptcy. These

⁹ *Accord, Rojas v. TK Communications, Inc.*, 87 F.3d 745, 750 (5th Cir.1996).

factors are often cited in support of the need for broad authority by bankruptcy courts to approve sales free and clear. The following policy considerations are often cited in support of such sales:

1. Purchasers must be protected or creditors of the debtor would merely follow the assets until they were in the hands of a solvent entity and then sue to recover.
2. The sales must have finality.
3. The Bankruptcy Code is designed to provide for equality of treatment of like claims.
 - a. It is not fair to allow certain creditors to pursue successor liability claims and recover in full when other creditors are forced to share piecemeal in the assets of the estate.
 - b. A purchaser will pay less on account of the additional risk of successor liability so the amount realized by creditors who do not pursue successor liability claims will be further reduced.
4. Protection against successor liability will maximize value realized for the debtor's assets.
 - a. The purchaser will pay more without the risk of future liability.
 - b. The purchaser can buy assets at going concern value.
 - c. There is more money for all creditors.
 - d. The assets can be liquidated efficiently, because the debtor does not have to resolve disputes about the validity and extent of competing interest in the property sold (the interests attach to the proceeds and the competing claims can be resolved at a later time).
 - e. Jobs are preserved because a sale in bankruptcy may permit a business to be sold as a going concern rather than piecemeal.

See, e.g., American Living Sys. v. Bonapel (In re All American of Ashburn, Inc.), 56 B.R. 186, 190 (Bankr. N.D. Ga. 1986); Rubinstein v. Alaska Pac. Consortium (In re New England Fish Co.), 19 B.R. 323, 328-29 (Bankr. W.D. Wash. 1982); aff'd, 805 F.2d 1515 (11th Cir. 1986).

However, not all courts are convinced that these policy considerations justify a broad interpretation of the bankruptcy court's power to authorize sales free and clear, or that such considerations are, in fact, advanced, by a liberal reading of the court's power. The following countervailing policy considerations have been noted by a number of courts:

1. Some courts discount the chilling effect that successor liability has on asset sales. *See, e.g., Chicago Truck Drivers, Helpers and Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 50-51 (7th Cir. 1995).
2. Such sales may lead to fraud and collusive dealings.
3. Other federal policies may be just as, if not more, important.
 - a. Protection against environmental hazards.
 - b. Protection against defective products.
 - c. Employee protection against sex and age discrimination. *See, e.g., Steinbach v. Hubbard*, 51 F.3d 843 (9th Cir. 1995) (collecting federal decisions supporting successor liability to vindicate statutory policies favoring employee protections).
4. The purchaser should not be allowed to have it both ways – enjoy the goodwill of the debtor's customer base while disavowing a responsibility to these same customers.

Since the concept of successor liability is itself an equitable doctrine¹⁰, these policy considerations play a critical role in the court's balancing of the interests of the bankruptcy estate as a whole and the interests of specific claimholders.

B. Transfer of Assets "Free and Clear"

To what extent does the Bankruptcy Code provide for the transfer of assets from a debtor to a purchaser free and clear of successor liability? Does successor liability constitute an interest in property that can be defeated under the Bankruptcy Code? Does it constitute a claim that can be discharged under the Bankruptcy Code? There are no clear answers to these questions and it is apparent that the courts have been struggling to find a way to resolve the competing policy considerations that underlie successor liability.

1. Sales pursuant to Section 363

One mechanism through which debtors may sell their assets "free and clear" in bankruptcy is section 363 of the Bankruptcy Code. Section 363(b)(1) provides generally that the trustee or debtor in possession "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate...." Subsection (f) deals with sales "free and clear" and provides as follows:

¹⁰ *Chicago Truck Drivers, Helpers and Warehouse Workers Union (Indep.) Pension Fund.*, 59 F.3d at 49.

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if –

- (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.

A critical issue under section 363(f) is what is an "interest" in property. Section 363(f) permits the trustee to sell property free and clear of "any interest" of a third-party in property of the estate; but the Bankruptcy Code does not define the term "interest." Bankruptcy courts have reached different conclusions as to what constitutes an interest in property. Some courts have construed the term "interest" narrowly to include only *in rem* interests, such as liens and security interests that attach to the property. A majority of courts, however, have interpreted the term more broadly, such that certain liabilities - including product liability claims, environmental remediation claims, and employment discrimination claims – are treated as interests that are extinguished through a 363 asset sale.

Representing the more restrictive view that “interests” are limited to *in rem* interests is *Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.)*, 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987), where the court held that “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.” However, the express language of Section 363(f)(3) makes it clear that an interest in property is not synonymous with a lien and that the former represents a broader concept. *See, e.g., 229 Main St. Ltd. P’ship v. Mass. Dept. of Env’tl. Prot. (In re 229 Main St. Ltd. P’ship)*, 262 F.3d 1 (1st Cir. 2001) (interest in property broader than lien); *WBQ P’ship v. Commonwealth of Va. (In re WBQ P’ship)*, 189 B.R. 97 (Bankr. E.D. Va. 1995) (a “lien” is a subset of an “interest”). Thus, what appears to be a majority of courts have held that section 363(f) is not limited to *in rem* interests. *See also United States v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F.3d 283 (3rd Cir. 2003); *In re P.K.R. Convalescent Centers, Inc.*, 189 B.R. 90, 94 (Bankr. E.D. Va. 1995) (“As the plain meaning of the statute demonstrates, § 363 covers more situations than just sales involving liens.”).

No court has been willing to go to the opposite extreme and hold that “interests” include all claims against the debtor, whether *in rem* or *in personam*. In *In re Leckie Smokeless Coal*

Co., 99 F.3d 573 (4th Cir. 1996), *cert. denied sub nom., United Mine Workers of America 1992 Benefit Plan v. Leckie Smokeless Coal Co.*, 520 U.S. 1118 (1997), the Fourth Circuit specifically rejected such a position, noting that it had previously held in *Yadkin Valley Bank & Trust Co. v. McGee (In re Hutchinson)*, 5 F.3d 750, 756 n.4 (4th Cir. 1993) that “courts have recognized that general, unsecured claims do not constitute ‘interests’ within the meaning of Section 363(f).”

Unfortunately, the term “interest” is not defined in the Bankruptcy Code. In Section 361 of the Code, it is synonymous with a secured claim that is entitled to adequate protection. In Sections 501 and 502 of the Code, it refers to equity rights in the debtor. It is not possible to glean its meaning as used in Section 363(f) by reference to its use elsewhere in the Code.

By contrast, the term “claim” is defined in Section 101(5) of the Code and is intended to be given a broad definition. However, the term “claim” does not appear in Section 363(f). Thus, while there is little doubt that the debtor can transfer assets pursuant to Section 363(f) free and clear of a secured claims, since such a claim constitutes an interest in the debtor’s property, it is not clear what other types of claims, if any, can be affected by a sale free and clear.

An example of a case is *Leckie Smokeless*, discussed above. In that case, the debtors sought to sell their assets free and clear of any liability under the Coal Act. The UMWA Combined Benefit Fund (“Fund”) and the UMWA Benefit Plan (“Plan”) held claims for future pension and health benefit plan payments and argued that the bankruptcy court did not have authority under section 363(f) to authorize a sale free and clear of such claims. The Fourth Circuit found that the Fund and the Plan had “claims” as that term is broadly defined in the Bankruptcy Code, even though the claims were unmatured and contingent, because the liability arose pre-petition. More importantly, it held that the claims constituted “interests in property” of the debtors as that term is used Section 363(f). While the court did not have a problem finding that the “interests” referred to in Section 363(f) were not limited to *in rem* interests, it ultimately declined to articulate its own test for what types of claims were “interests in property.” Instead, it limited its ruling to a finding that the claims for future plan payments created interests in the assets to be sold because the claims arose out of the debtor’s use of the assets. Therefore, the court concluded, a sale pursuant to section 363(f) eliminated the interests in the assets sold as well as the buyer’s successor liability.

Thereafter, in *United States v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F.3d 283 (3rd Cir. 2003), the court was faced with a motion by the debtor to sell substantially all of its assets to American Airlines. At the time, TWA was defending various employment discrimination claims under Title VII and ADEA and had settled other sex discrimination claims brought by flight attendants by awarding them travel vouchers. TWA proposed to sell its assets free and clear of the travel voucher claims and the discrimination claims over the objections of the claim holders. Relying on the Fourth Circuit holding in *Leckie Smokeless*, the Third Circuit found that such claims were interests covered by section 363(f).

The Eighth Circuit followed the holding of *TWA* in *Cibulka v. Trans World Airlines, Inc.*, 92 Fed. Appx. 366, 368 (8th Cir. 2004). It has also been followed in *Faulkner v. Bethlehem Steel/Int’l Steel Group*, 2005 WL 1172748 (N.D. Ind., April 27, 2005), *Myers v. United States*, 297 B.R. 774, 780-83 (S.D. Cal. 2003), and *John T. Callahan & Sons, Inc. v. Dykeman Elec.*

Co., Inc., 266 F. Supp. 2d 208, 222 (D. Mass. 2003). However, at least one bankruptcy court has declined to follow the Third Circuit's *TWA* decision. See *In re Eveleth Mines, LLC*, 312 B.R. 634 (Bankr. D. Minn. 2004).

2. Sales pursuant to Section 1123 and 1141(c)

Section 1123 describes what can be included in a chapter 11 plan. Section 1123(a)(5)(D) states that a plan may provide for the "sale of all or any part of the property of the estate, either subject to or free of any lien . . ." Section 1141(c) provides that, except as otherwise provided in the Code or in the plan, "after confirmation of a plan, the property dealt with by the plan is free and clear of **all claims and interests** of creditors, equity security holders, and of general partners in the debtor" (emphasis added).

Unlike section 363(f) of the Bankruptcy Code, Section 1141(c) specifically provides for a transfer of assets of the debtor free of "claims" as well as "interests." For this reason, when a sale takes place pursuant to a confirmed plan, the issue that the Fourth Circuit struggled with in *Leckie Smokless* as to whether the sale is free and clear of claims is arguably eliminated. Unfortunately, most asset sales take place pursuant to Section 363(f) and not pursuant to plans under Section 1141(c) due to time constraints.

Furthermore, the inclusion of claims in Section 1141(c) does not, in and of itself, resolve the issue of whether a successor liability claim constitutes the type of "claim" that can be eliminated through a sale in a bankruptcy proceeding. There are a number of cases that have held that Section 1141(c) can preempt successor liability claims – see, e.g., *White Motor Credit Corp.* – but the issue is far from resolved, particularly given the due process implications.

3. Successor liability claims that are extinguished by a sale free and clear

In the *White Motor Credit Corp* case, the bankruptcy court held that its "equitable power to sell free and clear must be interpreted consistent with its power to discharge claims under a plan of reorganization." 75 B.R. at 948-49. That inquiry leads back to the issue of due process which, in turns, requires a determination of (a) when the claim arises and (b) what notice must be afforded the claimholder.

a. When does a claim arise?

The difficulty with determining when a claim arises, particularly environmental and product liability claims, is that they are often based on past conduct as well as ongoing responsibility and future harm. In determining when the claim arises for bankruptcy purposes, courts have taken four different approaches:

- i. State Law Accrual Test – The courts apply state law to determine when a claim arises. See *Matter of M. Frenville Co.*, 744 F.2d 332 (3d Cir. 1984); *cert. denied*, 469 U.S. 1160 (1985).

ii. Conduct Test – The courts look to when the offensive conduct actually occurred. This test is obviously problematic with respect to environmental and products liability claims, because the harm may not occur or become known until many years after the conduct has taken place. *See Waterman S.S. Corp. v. Aguiar (In re Waterman S.S. Corp.)*, 141 B.R. 552, 556 (Bankr. S.D.N.Y. 1992), *vacated*, 157 B.R. 220 (S.D.N.Y. 1993).

iii. Relationship Test – The courts look to determine whether the injured party had a specific prepetition relationship with the debtor at the time the conduct which caused the injury occurred. *See United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997, 1004-1006 (2d Cir. 1991).

iv. Due Process Test – The courts look at the "totality of the circumstances." Under the due process test, courts consider temporal knowledge and notice key issues in determining whether a claim has been discharged in bankruptcy. For the claim to be discharged, it must be shown that (a) Company A had sufficient knowledge of the nature and scope of the liability giving rise to the action such that it could fairly anticipate having to provide for the liability as part of its financial restructuring; (b) the asserted liability was of such a nature that it was reasonably possible to deal with it as a claim in the bankruptcy proceeding; and (c) the claim was in fact dealt with fairly and responsibly. *See Fairchild Aircraft Corp. v. Campbell (In re Fairchild Aircraft Corp.)*, 184 B.R. 910 (Bankr. W.D. Tex. 1995), *vacated* 220 B.R. 909 (W.D. Tex. 1998).

b. Notice to the Claimholder

Notice is an “elementary and fundamental requirement of due process.” *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950). The adequacy of notice is therefore a key issue in successor liability cases. *See Western Auto Supply v. Savage Arms (In re Savage Indus., Inc.)*, 43 F.3d 714 (1st Cir. 1994) (adequate notice necessary to satisfy the requirement of due process).

What constitutes adequate notice "is fact-specific and depends upon whether or not the claimants are identifiable. *See generally* Ralph R. Mabey & Jamie A. Gavrin, *Constitutional Limitations on the Discharge of Future Claims in Bankruptcy*, 44 S.C. L. REV. 745 (1993); Ralph R. Mabey & Peter A. Zisser, *Improving the Treatment of Future Claims: The Unfinished Business Left by the Manville Amendments*, 69 AM. BANKR. L.J. 487 (1995). In addition, some courts have held that due process requires meaningful participation in the bankruptcy process, perhaps through a court-appointed legal representative. *See Fairchild Aircraft Corp.*, 184 B.R. at 912; *Waterman S.S. Corp.*, 141 B.R. at 556.

The adequacy of notice is, in large part, a function of the ability of the parties to identify the claimants. For example, where the claimants are "readily ascertainable," actual notice is required so that the claimant can timely and effectively assert its rights in the bankruptcy case. *See Solow Bldg. Co., LLC v. ATC Assoc., Inc.*, 175 F. Supp. 2d 465 (E.D.N.Y. 2001) (the inquiry is whether, at the time of the bankruptcy, claimants could have ascertained through reasonable due diligence that they had a claim against the debtor). Actual notice usually means service by mail of the proposed action. Accordingly, it has been held that the failure to provide notice to the holder of a successor liability claim whose identity is known or reasonably ascertainable renders a sale "free and clear" subject to the successor liability claim. *See Western Auto Supply; United States v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F. 3d 283 (3d Cir. 2003).

When the claimants are not identifiable, there is no bright line rule as to what constitutes adequate notice. Thus, for example, where the class of claimants is large or the claimants are unknown, notice by publication in print or broadcast media might be sufficient. *See Buttes Gas & Oil Co. v. California Reg'l Water Quality Bd. (In re Buttes Gas & Oil Co.)*, 182 B.R. 493, 497 (Bankr. S.D. Tex. 1994) ("Publication in a newspaper or journal that will be received across the U.S., such as the *Wall Street Journal* or the *New York Times*, and/or publication in a local paper where the company does business is generally understood to be sufficient notice to unknown creditors"); *Fairchild Aircraft Corp.*, 184 B.R. at 930 (Bankr. W.D. Tex. 1995) ("For those persons whose injuries have yet to 'manifest' themselves, [notice by publication] would be far from perfect . . . , under the circumstances, and given the countervailing social policy of assuring at least some payment for the broadest range of persons, that might be all the notice required"). *See also Western Auto Supply.*

c. Notice to holders of future claims

Future claims present the greatest challenge in terms of due process. For this reason, many courts have held that assets cannot be sold through the bankruptcy process free and clear of such claims, notwithstanding the policy considerations that favor sales free and clear.

Along the time continuum of the bankruptcy case, there are three categories of future claims assuming the reference point is the petition date. The first category includes claims that arise after the petition date but before the sale of assets. Such claims are not truly "future" claims as far as the sales transaction goes, since the claim exists at the time the court is called upon to approve the sale. The true future claims are those that arise either following the asset sale but before plan confirmation, or after plan confirmation.

i. Post-sale/Pre-confirmation claims

Post-sale/pre-confirmation claims are generally dischargeable if the claimant had sufficient knowledge or adequate notice of the claim against the debtor in order to timely assert its rights in the bankruptcy case. *See CMC Heartland Partners v. Union Pacific R.R. (In re Chicago, Milwaukee, St. Paul & Pacific R.R. Co.)*, 974 F.2d 775, 786 (7th Cir. 1992) ("When a potential claimant knows that an identifiable responsible person, as defined by CERCLA, caused a release of a hazardous substance on the claimant's property so that response costs are imminent

and when, in fact, the claimant takes some tests toward testing the containment, we see no reason to split hairs and hold that the claimant must first receive test results from a lab before it has a claim or a contingent claim which must be brought in order to avoid discharge.").

Claims arising from damages that are sustained after a sale but prior to plan confirmation will not support an action for successor liability, because such claims can generally be dealt with under the plan. In such cases, even though the injury occurred post-petition, the claim may be regarded as a pre-petition claim because the defective product causing the injury was manufactured and sold pre-petition. *See Piper Aircraft Corp. v. Calabro (In re Piper Aircraft Corp.)*, 169 B.R. 766 (Bankr. S.D. Fla. 1994) (holding that a product liability claim for personal injuries caused by a defective airplane which was manufactured by the debtor pre-petition but crashed post-petition prior to plan confirmation was a pre-petition claim which could be addressed in the plan); *Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.)*, 75 B.R. 944 (Bankr. N.D. Ohio 1987) (enjoining product liability claims where the injuries occurred after the sale of assets but before a plan had been confirmed).

ii. Post-confirmation claims

For claims arising after plan confirmation but before the bankruptcy estate has been closed, there is a reasonable prospect that the court will permit the assets to be sold free and clear of successor liability claims unless the claimant can show that it was prejudiced by lack of notice of the sale. *See Paris Mfg. Corp. v. Ace Hardware Corp. (In re Paris Indus. Corp.)*, 132 B.R. 504, 509-510 (D. Me. 1991) (holding that the claimant must show prejudice, such that the bankruptcy court would not have approved the sale because the sales price was unfair); *ITOFCA Inc. v. MegaTrans Logistics Inc.*, 322 F. 3d 928 (7th Cir. 2003) (holding that a purchaser of intellectual property in a Section 363 sale was protected against a third party's claim for copyright infringement, where (a) the party was on notice of the proposed sale; (b) the party participated in the debtor's bankruptcy proceedings; and (c) the party never objected to the sale or the sale order).

However, in the case of certain post-confirmation claims, the bankruptcy court may no longer have jurisdiction over the claim. Particularly in the environmental context, claims may arise well after the bankruptcy case has been closed and all the assets distributed. In those instances, successor liability may exist despite an order approving the sale free and clear. *See Zerand-Bernal Group, Inc. v. Cox (In re Cary Metal Prod., Inc.)*, 152 B.R. 927, 935 (Bankr. N.D. Ill. 1993), *aff'd*, 23 F.3d 159 (7th Cir. 1994) (the bankruptcy court does not have jurisdiction to enjoin a products liability suit brought in a non-bankruptcy forum against a purchaser of the debtor's assets). Indeed, under the reasoning of decisions such as *Fairchild Aircraft Corp.*, such future claims are not bankruptcy claims within the meaning of the Bankruptcy Code and cannot be defeated by a sale authorized under either Sections 363(f) or 1141(c).

V. Practice Pointers For Minimizing The Risk Of Successor Liability

The issue of whether Company B can be held liable for the debts or liabilities of Company A under one of the recognized theories of successor liability is intensely fact-specific.

In some cases, the parties will know who the claimholders are or will be able reasonably to anticipate the nature of future claims that may be asserted against it and the identity of the claimants. In other cases, there may be no conceivable way to foresee these claims, let alone identify the claimants. Under either scenario, the best strategy is to incorporate as many means of protection against successor liability claims as are available under the circumstances of the transaction.

While not all of these strategies are possible in all cases, the following is recommended in order to minimize the exposure of Company B:

- A. Company B should have no greater resemblance to Company A than necessary.
- B. Avoid all suggestions that Company B's business is a continuation of Company A's business.
- C. Provide maximum notice of the proposed sale
 - 1. written notice to all parties in interest;
 - 2. written notice or publication to all contingent creditors or to a court-appointed representative;
 - 3. publication of notice to unknown creditors or to a court-appointed representative.
- D. Incorporate the Section 363 sale into the reorganization plan and have the confirmation order ratify the sale.
- E. Include provisions in the plan for creation and funding of a reserve or trust for unknown claimants and to indemnify Company B against future claims.
- F. Seek an injunction to prevent creditors from suing in order to minimize the indemnification claims against estate.
- G. Provide in the plan or sale order for Bankruptcy Court retention of jurisdiction over successor liability disputes.
- H. Provide for Company A to indemnify Company B from claims based on liabilities not expressly assumed in the asset purchase agreement.
- I. Specifically identify in the asset purchase agreement those assets that are not being purchased and those liabilities that are not being assumed.
- J. Include in the asset purchase agreement an express disclaimer of express or implied assumption of liabilities.

- K. Do not assume employment contracts. Enter into new employment agreements and do not agree to hire specific employees of Company A.
- L. Do not keep Company A's business name, trade name, or product names.
- M. Do not have the same officers, directors and shareholders as Company A.
- N. Do not purchase Company A's assets with Company B's stock.
- O. Do not specifically purchase the goodwill of Company A.
- P. Incorporate broad releases into the Section 363 order and confirmation order.
- Q. Obtain express consents from creditors with an interest in the assets being sold, rather than relying on their failure to object.
- R. Separate Company A's business activities from Company B's activities (i.e., do not honor existing purchase orders or accept returns).
- S. Include a specific finding in the order approving the Section 363 sale or plan that Company B is not a successor to Company A, that the sale is not a *de facto* merger or consolidation, that Company B is acting in good faith and that price is fair.
- T. Have the order approving the sale provide Company B with an administrative claim for indemnification by Company A.
- U. Clearly distinguish Company B's products from Company A's products.