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Feature

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Caveat Emptor for § 363 Sales?

Known Creditors, Successor Liability and Notice Issues from the GM Chapter 11 Case

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In *Elliott v. GM LLC*,[1] the Second Circuit recently reinforced the importance of honoring the core bankruptcy requirements of disclosure and adequate notice by overruling the bankruptcy court's finding that a "free and clear" sale order protected a purchaser from successor liability claims by known creditors.[2] The court confirmed that known creditors are entitled to actual notice of proceedings that will affect their rights in bankruptcy and therefore cannot be bound to a resulting order by mere publication notice — even in the face of claims of overarching exigency that threaten the entire American economy.

The Sale of "Old" GM

In the midst of the 2008-09 financial meltdown, General Motors Corp. (Old GM), supported by the federal government, raced through a chapter 11 bankruptcy at lightning speed. General Motors LLC (New GM) emerged just 40 days after its filing by way of its purchase of most of Old GM's assets through a § 363 sale, purportedly "free and clear" of all liens, claims or interests (including successor-liability claims). A quick exit from bankruptcy for New GM was critical, as it was argued that a quick sale was necessary to avoid the risk of catastrophic disruptions to the national economy.

The asset sale was approved by a sale order containing broad injunctive language purporting to bar "rights or claims ... based on any successor or transferee liability" against New GM (the "enjoined claims"), other than certain obligations that New GM expressly agreed to assume.[3] The enjoined claims were channeled to a trust established to address unsecured claims against Old GM. Given the difficulty of assailing asset sale orders, it appeared that this was the final word on the matter.[4]

Taking a Step Back

Not so fast, however. Well before its bankruptcy, Old GM began receiving and evaluating reports of allegedly defective ignition switches in many models of its vehicles. This problem could cause a car's engine to shut off while moving, disabling air bags and other highly dangerous effects. No recall was instituted by New or Old GM before or during the bankruptcy, and the purchasers of these vehicles had no actual notice of their claims in the bankruptcy, even though Old GM had actual or constructive knowledge of this problem.[5] This defect eventually resulted in many injuries, deaths and significant property damage. However, Old GM never attempted to provide actual notice of the proposed § 363 sale at the relevant time to the then-known owners of the defective vehicles, relying instead on publication notice.

New GM belatedly ordered a recall for millions of vehicles in 2014, well after the bankruptcy sale. Following the recall announcement, dozens of class-action lawsuits were filed against New GM, alleging liability for the tortious conduct of both Old and New GM. New GM immediately sought to enjoin all of the claims through enforcement of the sale order by the bankruptcy court. The claims that New GM sought to enjoin fell into four general categories: (1) pre-sale closing accident claims,

1 829 F.3d 135 (2d Cir. 2016). *See also* C.R. "Chip" Bowles and Jacob C. Cohn, "Bankruptcy Courts Lack Jurisdiction to Enjoin Independent Tort Claims against Nondebtors," XXIX *ABI Journal* 5, 34-35, 55, June 2010, *available at* abi.org/abi-journal (discussing constitutional notice requirements).

2 *Id.*

3 *In re Motors Liquidation Co.*, 529 B.R. 510, 534 (Bankr. S.D.N.Y. 2015).

4 *See, e.g.*, C.R. "Chip" Bowles, "Bankruptcy's Verdun? The Report from the Lehman Sale Front," XXIX *ABI Journal* 4, 36, 64-65, May 2010; C.R. "Chip" Bowles, "Who Do You Trust? The Continuing Saga of the Lehman Brothers Sale," XXIX *ABI Journal* 2, 28-29, 63-64, March 2010. Both of these articles are *available at* abi.org/abi-journal.

5 *In re Motors Liquidation Co.*, 529 B.R. 510, 538 (Bankr. S.D.N.Y. 2015).

(2) economic-loss claims arising from the ignition switch defect and other defects, (3) independent claims relating only to New GM's conduct, and (4) claims by used car purchasers who acquired post-sale cars that had been built by Old GM presale (the "claims").

Known Creditors Have Rights

The bankruptcy court held that all claims arising from Old GM's conduct fell within the scope of the sale order's injunction language concerning enjoined claims.[6] The court further held that while pre-sale owners of GM vehicles should have been given actual notice, they were not prejudiced because notice to them would not have affected the outcome of the sale order proceedings.[7] However, the bankruptcy court also found that claims by post-sale purchasers of pre-sale vehicles could not be enjoined, nor could claims based on the independent post-sale conduct of New GM.[8] The court certified its order for direct appeal to the Second Circuit, which took on the appeal.

The Appeal

The Second Circuit in *Elliott* first undertook to analyze what claims fell within the scope of the sale order's injunction. Next, the court addressed whether the sale-order injunction could be enforced against claimants who did not receive actual notice of the proposed sale.

What Did the Sale Cover?

On the issue of which claims the bankruptcy court had authority to address, and therefore to bar, by the sale order, the court was again forced to consider the following thorny questions: (1) What constitutes a "claim" for purposes of 11 U.S.C. § 101(5); (2) When does a "claim" arise where the liability-producing conduct of the debtor occurs pre-petition (*e.g.*, the manufacture and sale of a car with a defective switch in 2005), but the effect of the conduct harms the claimant post-petition (*e.g.*, the defective switch causes an accident in 2011); and (3) Can such an unknowing claimant be barred by a bankruptcy order entered before he has been injured?[9]

Citing its prior precedent in *In re Chateauguay Corp.*[10] and the Fifth Circuit's decision in *Lemelle v. Universal Mfg. Corp.*,[11] the Second Circuit in *Elliott* generally concluded that claims arising out of a debtor's pre-petition conduct are "claims" that can be addressed and discharged/channeled in bankruptcy, even if the injury giving rise to the claim occurs post-bankruptcy.[12] However, the court also held that some pre-bankruptcy contact or relationship must have existed between the debtor and the claimant in order to avoid "enormous practical and perhaps constitutional problems."[13] The court concluded:

> To summarize, a bankruptcy court may approve a § 363 sale "free and clear" of successor liability claims if those claims flow from the debtor's ownership of the sold assets. Such a claim must arise from a (1) right to payment (2) that arose before the filing of the petition or resulted from pre-petition conduct fairly giving rise to the claim. Further, there must be some contact or relationship between the debtor and the claimant such that the claimant is identifiable.[14]

Applying this framework to the four categories of claims before it, the court found that two categories were barred as enjoined claims and two were not. First, it concluded that claims arising from pre-sale closing accidents "clearly" were barred under the terms of the sale order scope.[15] Next, while it was a "closer call," the court held that post-sale economic-loss claims by owners of Old GM cars were barred because they had a pre-sale relationship with Old GM and held "contingent" claims at the time of bankruptcy.[16]

On the other hand, the Second Circuit held that the sale order could not be read consistently with bankruptcy law to include post-sale purchasers of Old GM vehicles because they were the classic unknown, unknowable and unknowing future claimants who had no pre-bankruptcy contact or relationship with Old GM and could not possibly know that they would someday have claims against GM for a car they would purchase in the future.[17] Lastly, the court held that claims against New GM for its own post-sale conduct (such as "misrepresentations by New GM as to the safety of Old GM cars") could not have been within the contemplation of the sale-order injunction because they were not based on Old GM's pre-petition conduct or any pre-petition right to payment from Old GM.[18]

What Could the Sale Order Cover?

Turning to the due-process challenge, the *Elliott* court was unmoved by New GM's arguments that the owners of cars with the defective ignition switches were "unknown" creditors in 2009 (or that it was not practical to give actual notice).[19] The court noted that, at the least, Old GM had records of the initial purchasers of the vehicles and, as for knowledge of the claims, the court concluded that Old GM either knew of the existence of the ignition switch defect or acted with reckless disregard of the facts:

> In the face of all the reports and complaints of faulty ignition switches, moving stalls, airbag non-deployments, and, indeed, serious accidents, and in light of the conclusions of its own personnel, Old GM had an obligation to take steps to "acquire full or exact knowledge of the nature and extent" of the defect.[20]

The Second Circuit likewise was unreceptive to New GM's argument that as contingent creditors, the claimants were not entitled to actual notice:

> The only contingency was Old GM telling owners about the ignition switch defect — a contingency wholly in Old GM's control and without bearing as to

6 *Id.* at 532.
7 *Id.* at 562-64.
8 *Id.* at 571-72.
9 *See* 829 F.3d at 155-57. For a fuller discussion of the power of a bankruptcy court to address tort claims that arise from pre-petition conduct but result in injury post-bankruptcy, *see* William P. Shelley and Jacob C. Cohn, "Unraveling the Gordian Knot of Asymptomatic Asbestos Claimants: Statutory, Precedential and Policy Reasons Why Unimpaired Asbestos Claimants Cannot Recover in Bankruptcy," *Mealey's Asbestos Bankruptcy Report* (May 12, 2004).
10 944 F.2d 997, 1005 (2d Cir. 1991).
11 18 F.3d 1268, 1277 (5th Cir. 1994).
12 859 F.3d at 155-56.
13 829 F.3d at 156.
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.* at 157-58.
18 *Id.*
19 *Id.* at 160.
20 *Id.* (internal citation omitted).

> Old GM's own knowledge. New GM essentially asks that we reward debtors who conceal claims against potential creditors. We decline to do so.[21]

Lastly, the court rejected any notion that the requirement of actual notice could be excused in light of the "extraordinary" need to rush the sale through because "Old GM's precarious situation and the need for speed did not obviate basic constitutional principles. Due process applies even in a company's moment of crisis."[22]

Having confirmed the bankruptcy court's holding that owners were entitled to actual notice, the court proceeded to reverse the bankruptcy court's determination that this due-process violation could be excused because the owners did not suffer "prejudice." The Second Circuit cited competing precedent but did not decide whether the lack of notice and an opportunity to be heard is prejudicial *per se* or whether prejudice must be affirmatively established. Instead, the court concluded that whatever the standard, the owners had been prejudiced as it "cannot say with fair assurance that the outcome of the § 363 sale proceedings would have been the same had Old GM disclosed the ignition switch defect and these plaintiffs voiced their objections to the 'free and clear' provision."[23]

The Second Circuit also rejected the bankruptcy court's conclusion that the owners' hypothetical participation in the sale order hearing would not have changed the outcome of the process or the language of the order. The court emphasized that the sale order was negotiated with the involvement of numerous constituencies, and that this "polycentric approach" led to New GM agreeing to assume substantial liabilities of Old GM that were not contemplated by the original proposed sale order, especially including Old GM's lemon law liabilities in the face of protests by numerous state attorneys general.[24] Further, the court emphasized that the fact that GM was under the control of the Treasury Department throughout this process resulted in bargaining opportunities that were influenced by political and public policy considerations not found in ordinary corporate reorganizations, noting:

> Opportunities to negotiate are difficult if not impossible to recreate. We do not know what would have happened in 2009 if counsel representing plaintiffs with billions of dollars in claims had sat across the table from Old GM, New GM, and Treasury.... [W]hile we cannot say with any certainty that the outcome would have been different, we can say that the business circumstances at the time were such that [the] plaintiffs could have had some negotiating leverage, and the opportunity to participate in the proceedings would have been meaningful.[25]

It has been said that bankruptcy is the friend of the honest-but-unfortunate debtor who lays bare his/her assets and liabilities, and identifies and notifies his/her creditors in exchange for a fresh start. Although here this was to be accomplished through a § 363 "free and clear" sale to a bankruptcy-remote "newco" rather than a § 1141(d) discharge, the basic principles are the same.

Fundamentally, the outcome of this case was driven by the belief of the bankruptcy and appeals courts that Old GM was less-than-honest about addressing its ignition switch defect problem in 2009. It was the conclusion that Old GM was sweeping a substantial and *known* problem under the rug that fueled the courts' conclusion that the owners of vehicles containing defective ignition switches were known, albeit contingent, creditors and were entitled to actual notice.

The decision also reinforces the fundamental limits on the authority of bankruptcy courts to enjoin claims in furtherance of efforts to reorganize a company or maximize the value of a sale of its assets.

What Does It All Mean?

This decision reinforces the overriding importance for debtors to forthrightly identify all of their creditors, including foreseeable contingent creditors, and make scrupulous efforts to provide all known creditors with actual notice where possible. As this case illustrates, the penalty for failing to do so is that the creditor that does not receive the required level of notice is not bound by *res judicata* to the bankruptcy court's orders. Even if a showing of "prejudice" is required, it is a lot easier to provide notice up front than to attempt to backfill the due-process hole in hindsight.

The decision also reinforces the fundamental limits on the authority of bankruptcy courts to enjoin claims in furtherance of efforts to reorganize a company or maximize the value of a sale of its assets. Future claimants with no prebankruptcy relationship to the debtor (here, post-sale secondhand purchasers of defective GM cars) cannot be bound to the orders and decrees of the bankruptcy court — certainly not without specifically providing them with meaningful virtual representation during the proceedings, such as the future claimants representative construct is intended to provide in the asbestos bankruptcy context.

Finally, the scope of relief available from a bankruptcy court does not extend to extinguishing, or channeling, the independent liabilities of nondebtors that are not derivative of the debtor's own pre-petition liability-causing conduct, such as the alleged post-sale conduct of New GM with regard to the ignition-switch defect. As *Elliot* emphatically confirms, bedrock constitutional requirements of due process can "trump" even seemingly compelling justifications for expedience. abi

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21 *Id.*
22 *Id.* at 161.
23 *Id.*
24 *Id.* at 147.
25 *Id.* at 163.