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The Second Circuit Articulates Standard For Determining Scope of Free and Clear Sale Provision and Highlights Procedural Due Process Concerns That Bear on Enforcement

The United States Court of Appeals for the Second Circuit recently articulated a standard to determine what claims may be barred against a purchaser of assets “free and clear” of claims pursuant to section 363(f) of the Bankruptcy Code and highlighted procedural due process concerns with respect to enforcement.¹ The decision arose out of litigation regarding certain defects, including the well-known “ignition switch defect,” affecting certain GM vehicles. GM’s successor (which acquired GM’s assets in a section 363 sale in 2009) asserted that a “free and clear” provision in the GM sale order barred successor liability claims relating to the defects. The Second Circuit held that the “free and clear” provision covered some of the ignition switch claims but found that the provision could not be enforced to enjoin all such claims because some claimants had not received adequate notice of the sale order.² The Second Circuit held that GM knew (or should have known) about the ignition switch defect which gave rise to those claims and thus was required to provide claimants with actual notice of the sale order, which it had not done.

Background

On June 1, 2009, General Motors Corp. (“**Old GM**”) filed for bankruptcy and sought authority to sell substantially all of its assets to General Motors LLC (“**New GM**”) in a section 363 sale. On June 2nd, the bankruptcy court ordered Old GM to provide actual notice of the proposed sale order to all known creditors of Old GM and publication notice (in newspapers, etc.) to all unknown creditors. In early July 2009, the bankruptcy court approved the sale and entered an order (the “**Sale Order**”) providing that the sale would be “free and clear of all liens, claims, encumbrances, and other interests of any kind or nature whatsoever, including rights or claims based on any successor or transferee liability,” with the exception of certain liabilities which New GM had agreed to assume.³

In February 2014, New GM began recalling cars built between 2002 and 2009 because of an ignition switch defect that could cause the ignition to turn off (and, thus, disable air bags, power steering and brakes), even while the cars were in motion. Numerous class action lawsuits followed. New GM sought to enforce the free and clear provision in the Sale Order to enjoin claims against New GM relating to the defect. The plaintiffs in the lawsuits had received publication, but not actual, notice of the Sale Order.

The bankruptcy court concluded that (1) the terms of the Sale Order applied to many of the claims at issue, and (2) while some ignition switch claimants had not received sufficient notice of the Sale Order,

they were not prejudiced by Old GM's failure in this regard and, thus, were not entitled to relief from the Sale Order. Accordingly, it held that the Sale Order protected New GM against "ignition switch claims that otherwise could have been brought against Old GM, unless those claims arose from New GM's own wrongful conduct."⁴ The bankruptcy court then certified its decision for direct appeal to the Second Circuit.⁵

The Second Circuit's Decision

The Second Circuit considered the scope of the Sale Order (and the bankruptcy court's power to approve section 363 sales "free and clear" of claims) and the enforceability of the GM "free and clear" provision with respect to the disputed claims.⁶

Application of the Sale Order to ignition switch claims.

In addressing the scope of the Sale Order, the Second Circuit held that a bankruptcy court may approve a section 363 sale "free and clear" of successor liability claims if: (1) the claims (a) "flow from the debtor's ownership of the sold assets," and (b) arise from a prepetition right to payment or a right to payment that "resulted from pre-petition conduct fairly giving rise to the claim[s]," and (2) "some contact or relationship [exists] between the debtor and the claimant such that the claimant is identifiable."⁷

Applying this test, the Second Circuit concluded that the Sale Order could bar "pre-closing accident claims" and "economic loss claims arising from the ignition switch defect or other defects" ("**Covered Claims**"), but not "independent claims relating only to New GM's conduct" or the claims of individuals who had purchased Old GM cars secondhand after the sale closed (and "had no relation with Old GM prior to bankruptcy").⁸

Sufficiency of the notice provided to ignition switch claimants.

The Second Circuit turned next to procedural due process considerations: did holders of Covered Claims receive adequate notice of the Sale Order via publication notice and, if not, are they bound by the "free and clear" provision?

The Second Circuit affirmed the bankruptcy court's ruling that holders of Covered Claims were entitled to actual, rather than publication, notice of the Sale Order. To determine whether actual notice is required, courts generally consider whether (1) the debtor knew or should have known about the claims, and (2) the identities of potential claimants are known or easily ascertainable.⁹ The Second Circuit noted that the record established that Old GM knew from the outset that the switch was defective and became aware of the consequences of defect almost immediately after installation began.¹⁰ The Court of Appeals stated that even if GM was unaware of the defect, the record below established that such ignorance could only be attributed to Old GM's failure to diligently follow leads that would have revealed it. The court observed

that federal law required Old GM to “keep records of the first owners of [its] vehicles . . . [and] [t]hus, to the extent that Old GM knew of defects in its cars, it would also necessarily know the identity of a significant number of affected owners.”¹¹ On this basis, the Court held that holders of Covered Claims deserved actual notice of the proposed sale order.

The Second Circuit disagreed with the bankruptcy court’s conclusion that claimants were not prejudiced by their failure to receive actual notice.¹² The bankruptcy court had reasoned that ignition switch claimants were not prejudiced by the notice deficiency because “[the court] would have approved the § 363 sale anyway, because the alternative was liquidation—and liquidation would have been catastrophic.”¹³ The bankruptcy court also noted that the claimants did not offer any “legally based arguments as to why they would have, or even *could* have, succeeded on the successor liability legal argument when all of the other objectors failed.”¹⁴

Rejecting the bankruptcy court’s reasoning, the Second Circuit observed that “the terms of the § 363 sale were not within [the bankruptcy court’s] exclusive control. Instead, the GM sale was a negotiated deal with input from multiple parties The Sale Order and Sale Agreement reflect this polycentric approach: it includes some fifteen sets of liabilities that New GM voluntarily, and without legal compulsion, took on as its own.”¹⁵ Accordingly, the prejudice the ignition switch claimants suffered was their deprivation of any opportunity to negotiate a consensual assumption by New GM of their claims.¹⁶

In light of the prejudice to the ignition switch plaintiffs resulting from their failure to receive adequate notice of the Sale Order and with that, the opportunity to negotiate, the Second Circuit held that such claimants were not barred from asserting claims against New GM.

Takeaway

The Second Circuit’s decision highlights the importance of providing adequate notice to *all* known creditors (even if they do not yet have fixed claims), and the dramatic consequences that can follow from a failure to provide such notice. The extent to which the decision will impact section 363 sales going forward with respect to notice, due diligence or other matters remains to be seen.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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¹ *Elliott v. General Motors LLC (In re Motors Liquidation Co.)*, ___ F.3d ___, 2016 WL 3766237 (2d Cir. July 13, 2016).

² In its decision, the Second Circuit considered four groups of claims asserted against New GM: “(1) pre-closing accident claims, (2) economic loss claims arising from the ignition switch defect or other defects, (3) independent claims relating only to New GM’s conduct, and (4) Used Car Purchasers’ Claims.” *Id.* at *13. With respect to “claims based in non-ignition switch defects,” the court concluded that the record was insufficient to determine whether such claimants had received adequate notice and accordingly remanded the matter. *Id.* At 21.

³ *Id.* at *3.

⁴ 2016 WL 3766237, at *8.

⁵ The bankruptcy court and Second Circuit addressed certain other issues not discussed here, including whether claims against the trust established to provide recoveries to Old GM’s general unsecured creditors were equitably moot.

⁶ Section 363 of the Bankruptcy Code permits a debtor, under certain circumstances, to sell property of the estate “free and clear of any interest in such property.”

⁷ 2016 WL 3766237, at *13.

⁸ *Id.* at *13-14. The Second Circuit wrote that “[t]here could have been no contact or relationship—actual or presumed—between Old GM and [the used car purchasers], who otherwise had no awareness of the ignition switch defect or putative claims against New GM” and, thus, it could not, “consistent with bankruptcy law, read the Sale Order to cover their claims.” *Id.* at *14.

⁹ *Id.* at *15.

¹⁰ *Id.* at *16.

¹¹ *Id.* at *16 (citing 49 U.S.C. § 30117(b)(1)).

¹² The Second Circuit questioned, but did not decide, whether a claimant aggrieved by a due process violation needs to demonstrate prejudice, noting that, to the extent it is required, claimants had demonstrated prejudice.

¹³ 2016 WL 3766237, at *21.

¹⁴ *In re Motors Liquidation Co.*, 531 B.R. 354 (Bankr. S.D.N.Y. 2015) (Gerber, J.).

¹⁵ 2016 WL 3766237, at *19.

¹⁶ While the Second Circuit could not conclude “with any certainty that the outcome would have been different,” it reasoned that “the business circumstances at the time were such that plaintiffs could have had some negotiating leverage,” in perhaps negotiating a voluntary assumption of liabilities in connection with the ignition switch defects, “and the opportunity to participate in the proceedings would have been meaningful.” *Id.*