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Who is left holding the bag for latent damage claims?

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Increasingly, true reorganizations under Chapter 11 are the exception, not the rule, as corporate debtors utilize bankruptcy sales to maximize asset value and pay creditors. This trend blurs the line between reorganizations and liquidations, as many Chapter 11 filings repurpose the disposition of assets via going concern sales to purchasers without associated liabilities and interests, which attach to sale proceeds payable to administrative expenses, lienholders, unsecured creditors and equity.

The Bankruptcy Economy

Asset value is maximized by "free and clear" sale provisions set forth in Section 363(f) of the Bankruptcy Code — and the finality of such sales. These concepts are paramount to bankruptcy practitioners and the system alike, and drive a certain "bankruptcy economy" for ALL cases and sales, where debtors, creditors and purchasers rely on these concepts to market and close transactions at their highest value with the cleanest title available at law.

Bankruptcy transactions are governed by bankruptcy court sale orders, and many times, such sale orders are in furtherance of a confirmed Chapter 11 plan that can utilize certain transfer tax exemptions provided only in a Chapter 11 confirmation order, which again maximizes the net proceeds for a bankruptcy estate. And Chapter 11 plans ensure equal treatment of similarly situated creditors. As such, bankruptcy sale orders and plan confirmation work together for all constituents as part of this bankruptcy economy as:

- The purchaser acquires the desired assets, clean title and seemingly unfettered insulation from prior liabilities associated with the assets and the selling company in an expedited manner governed by an open, judicial sale process;

- The debtor/seller fulfills its fiduciary duty to creditors by maximizing the value of its assets and receives a discharge with respect to all claims and interests it includes in the bankruptcy, with those claims attaching to the proceeds and other estate property and funds; and

- The creditors obtain the benefit of the assets being fully marketed and monetized at their highest remaining value promoting an improved overall distribution and equal treatment among similarly situated creditor groups.

Approved competitive bidding bankruptcy sales and confirmed plans are supposed to be a utilitarian-like situation for constituents involved in, or affected by, the bankruptcy proceedings. However, there is an untold and many times unaccounted group of "liabilities" that do not get (adequately) addressed as part of most bankruptcy proceedings: latent damage obligations.

Dormant Defects and Latent Damages

Latent damage claims are held by persons or companies that are affected by the repurposed asset with prepetition dormant defects, that only suffer their injury (or more precisely, only suffer their damages or connect their damages to the repurposed asset) post-confirmation. Bankruptcy cases have been able to address latent tort claims with Section 524(g) channeling injunctions and trusts in the asbestos case context, or otherwise establish future claims trusts in cases with massive "known" defects with un-manifested or unaccounted injuries and damages.

The majority of bankruptcy cases, however, do not involve nor merit Section 524(g) channeling injunctions or future claims trusts. As such, when latent damage claimants pursue litigation against the asset purchaser — who is reaping the profits and holding itself out as the owner of such asset — the purchaser and/or the debtor (hello, indemnification sale provisions) usually seek relief in the original bankruptcy court to enforce the discharge and/or other injunctions provided by a final, non-appealable confirmation order and/or sale order that otherwise was duly served on all known creditors by CM/ECF or regular mail processes, and many times served on all unknown creditors by court-approved publication notices in newspapers, industry specific periodicals and other online mechanisms.

Undercard Issues of a 101(5) Claim

An undercard of threshold issues present themselves many times in these situations, but are affected by different facts or varying circuit-level holdings, such as whether the latent damage liability is even a claim under Section 101(5) of the Bankruptcy Code or when such claim is deemed to arise in a given circuit, which of course is a prerequisite for a claim to be deemed (and perhaps was) discharged by the confirmation order and/or sale order.

Similarly, different cases have varying facts about pre-existing knowledge of manufacturing defects by the debtor and/or asset purchaser (see recent ongoing post confirmation bankruptcy litigation in GM pending in the Southern District of New York, In re Motors Liquidation Company, f/k/a General Motors Corp., Case No. 09-50026, (and now the U.S. Court of Appeals for the Second Circuit) or perhaps about the defective form and manner of the notice of the bankruptcy case, claims bar date, and confirmation order affecting notions of due process. See an interesting example of this from a case in which this author was involved a few years ago regarding cemetery improprieties, called Alderwoods Group, Inc. v. Garcia, et al., 420 B.R. 609 (Bankr.S.D.Fla. 2009)).

Again, these "other" issues can be dispositive by themselves in post confirmation litigation, for instance taking the example of successor liability claims and their dischargeability, or whether an asset purchaser can use a sale order or confirmation order as a shield to protect against its own misconduct with respect to the purchased assets.

On the one hand, there is a growing trend of bankruptcy courts determining that the "free and clear" language of Bankruptcy Code Section 363(f) may include successor liability claims among "interests in such property" immunizing the purchaser, and merely attaching to estate sale proceeds. However, on the other hand, courts are showing a similarly strong trend that a latent or future claim victim may pursue an asset purchaser for damages strictly rooted to the asset purchaser's post confirmation (mis)conduct in handling a defective product in the marketplace, where the claim is NOT about successor liability for the debtor's pre-confirmation conduct, but rather is a standalone claim against the asset purchaser only looking at its conduct after confirmation.

The current debate in the GM case now up on appeal is a very good example of just how hard it is to decipher a stand-alone claim when the post-confirmation misconduct by the asset purchaser is knowingly continuing a defective product line in the marketplace that was manufactured prepetition by the debtor and/or failing to timely recall that product or otherwise not adequately advising consumers about the risks involved with purchasing and continuing to use that product.

These undercard issues can fill up an entire article by themselves, including the effect on seeking punitive damages in the post-confirmation context (which is what really moves the needle in boardrooms), and will be left for another day, but usually these issues have a meaningful effect on such post-confirmation litigation.

Sale Immunity Versus Due Process

This is where two of the most fundamental, heavyweight concepts in bankruptcy law come to a head: the "free and clear" provisions of bankruptcy sales versus due process. In reconciling the bankruptcy sale objectives with the bedrock notions of due process, one should consider the famous bridges hypothetical from the Second Circuit:

> Consider, for example, a company that builds bridges around the world. It can estimate that of 10,000 bridges it builds, one will fail, causing 10 deaths. Having built 10,000 bridges, it becomes insolvent and files a petition in bankruptcy. Is there a "claim" on behalf of the 10 people who will be killed when they drive across the one bridge that will fail someday in the future? The potential victims are not only unidentified, but there is no way to identify them. Sheer fortuity will determine who will be on that one bridge when it crashes. What notice is to be given to these potential "claimants"?

In re Chateaugay Corp., 944 F.2d 997, 1003 (2d Cir.1991).

And while some people will think immediately about a future claims representative in the bridges-stype case with a large-scale known forthcoming damage claim without identified claimants, there are many middle-market cases or smaller, where having a future claims representative is not plausible or fiscally responsible to the known creditors in the case, or where the product itself is not inherently known to be the subject of forthcoming damage claims. Ultimately, the key question is what is considered due process for a latent damage claimant who did not know of the defect at the time of the bankruptcy or was not hurt by the defect manifestation until after the bankruptcy?

Let us add to the bridges-type hypothetical a bankruptcy-related sale process as the best way to maximize the value of the debtor's assets for creditors. With due process concerns present and inconsistent treatment of such liabilities in the post-confirmation litigation case law, then — even with tightly drafted 363(f) and 1141(c) provisions immunizing the purchaser and debtor from further liability — there remains the potential for purchasers to pay less for assets in bankruptcy because of uncertainty over liability. And existing creditors not only are affected by this potential lower purchase price, but unsecured creditors receiving ratable distributions in the Plan may receive disparate treatment compared with those unsecured latent damage claimants seeking a dollar for-dollar recovery against the asset purchaser. Disrupting asset value maximization and the equal creditor treatment continuum can become a recipe for disaster for all constituents in the bankruptcy economy, and has proven to be of great concern in bankruptcy jurisprudence.

However, as the district court in the Southern District of New York advised in a bankruptcy appellate capacity in In Re Grumman Olson Industries, Inc., 467 B.R. 694 (S.D.N.Y. (2012)), despite the strong policy and case law favoring enforcement of bankruptcy court sale/confirmation orders limiting the rights of injured parties, where parties either had no notice of the bankruptcy proceedings or, more importantly, no reason at the time to present an interest in the bankruptcy proceedings (even if they were generally aware of the bankruptcy proceedings) or to take any action in response to the threatened deprivation of their rights, enforcing sale/ confirmation orders in such instance would violate due process and bankruptcy notice concerns. Id. at 705- 709 (internal citations omitted).

Ultimately, the Grumman Olson court surmised that "[c]ourts have rejected the premise that maximizing the value of the estate outweighs the due process rights of potential claimants." Id. at 711.

Where Does This Leave the Bankruptcy Economy?

So, where does this leave the bankruptcy economy and the underbelly of future latent damage claimants? Plenty of cases thread the needle to foreclose certain successor liability claims, especially in mega-cases like GM, and there is still the host of undercard issues discussed earlier that many times answer the smaller questions disposing of the matter before reaching the ultimate larger discussion and conclusion reached in Grumman Olson. As such, there remains a discernible variance as to the consequences of latent damage claims in bankruptcy cases relative to enforcing injunctions in sale/confirmation orders.

In many instances, it is latent damage claimants who are left with restricted rights, if any, outside of bankruptcy, and are affected negatively by a process that did not involve them at all. In other cases, the specter of potential latent damage claims will affect the purchase price attained by the bankruptcy asset sale to the detriment of creditors and perhaps debtors. Then, of course, there are those cases where the asset purchaser will face lawsuits on their merits for successor liability-type actions or for standalone post-confirmation misconduct relative to the purchased defective assets despite premising its court approved purchase of such assets on immunizing themselves from liability with respect to the assets.

Accounting for Failure

Asset purchasers should be aware of the limits of “free and clear” language and discharge relief provided in bankruptcy orders no matter how tightly drafted or the breadth of indemnification provisions in transaction documents.

In situations with known defects surrounding the assets, asset purchasers — in addition to seeking broad Section 363(f) and indemnification language in bankruptcy orders and sale documents — may want to consider pushing for a future claims representative or a holdback reserve for any latent damage claims with such reserve being either on the estate or purchaser side. And while a competitive bid scenario may engender different terms and provisions on these points, inclusion of such items may affect notions of the "highest and best" bid. There is room here both for creativity and improving the treatment of latent damage claims, while maximizing the return to creditors.

Ultimately, despite Section 363(f) and 1141(c) relief, asset purchasers need to account for this additional risk component in their purchase price. In a normative world, case law or legislation would provide uniform treatment of latent damage claims in the post-confirmation/ post-sale setting.

One idea is for the United States Supreme Court to resolve the varying circuit standards as to when a Section 101(5) Claim arises for bankruptcy discharge purposes, but the differing state law standards for the accrual of latent damage claims may prove too difficult to overcome. Other cases focus on successor liability in the bankruptcy sale context but, as shown in GM, legal minds still cannot agree whether a given purchaser's conduct with respect to a latent defective product falls within successor liability or a standalone, independent claim.

Finally, while constitutional due process relative to the treatment of latent damage claims in a bankruptcy sale order and confirmation order is guided by general due process pronouncements in Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950) and more specific discussions in cases like Grumman Olson and those referenced there finding that due process trumps 363(f), other cases retreat from that basic principle and peel back due process with notions of proving prejudice, overcoming mootness, and other similar issues.

More settled law and legislation on the treatment of latent damage claims in the post-confirmation/ post-sale context would engender a more predictive analysis and level playing field for asset purchasers and hopefully a uniform treatment of latent damage claims in sale orders and confirmation orders. However, the current uncertainty involved as to the treatment of latent damage claims in bankruptcy cases (which can be fact-specific) may actually work in favor of some asset purchasers who are more risk-tolerant and better understand the bankruptcy terrain than competitors in their marketplace, which yet again contributes favorably to the existing bankruptcy economy sustaining the lifeblood of debtors and creditor recovery alike.