

Second Circuit Pumps Brakes on General Motors and “Free and Clear” Asset Sales

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Seven years after speeding its way through a bankruptcy court approved transformation to a new company, General Motors faces a major roadblock. The Second Circuit Court of Appeals has ruled that vehicle owners may pursue GM for successor liability for vehicle defect claims that arose prior to its bankruptcy filing.

General Motors Corporation – a/k/a “Old GM” – filed for chapter 11 bankruptcy in June 2009. Within 40 days of the bankruptcy filing, the United States Bankruptcy Court for the Southern District of New York approved a sale of assets from Old GM to General Motors, LLC – a/k/a “New GM”. The Bankruptcy Court entered an order approving the sale (the “Sale Order”) under Section 363 of the Bankruptcy Code, which permits sales of assets free and clear of all liens, claims and encumbrances, and enjoins creditors from pursuing such claims against a purchaser. Accordingly, New GM argued to the Bankruptcy Court, and then the Second Circuit, that it is not responsible for any vehicle defect claims that arose prior to the June 2009 bankruptcy filing.

In 2014, New GM instituted a series of recalls of millions of vehicles based upon a defect that caused electrical systems in vehicles to shut down unexpectedly. Numerous lawsuits were filed against New GM by plaintiffs generally alleging that (1) these defects were known to Old GM at the time of the 2009 sale, (2) the plaintiffs had not received actual notice of the bankruptcy sale, and (3) the plaintiffs were free to pursue their claims against New GM on various theories, including successor liability.

The issue of whether the plaintiffs’ claims were barred by the Sale Order was brought before the Bankruptcy Court. The bankruptcy judge ruled that, while the plaintiffs were entitled to receive actual notice of the sale under due process principles, the Court would have approved the sale even if they had received notice, and equitable mootness barred the pursuit of the claims. As a result, the bankruptcy judge upheld the Sale Order’s injunction prohibiting the pursuit of claims against New GM, and the plaintiffs appealed.

On July 13, 2016, the Second Circuit reversed the Bankruptcy Court’s decision, thereby permitting the plaintiffs to pursue claims relating to vehicle defects against New GM on successor liability theories. Commenting on due process concerns, the Second Circuit stated that the “the need for speed does not obviate basic constitutional principles.” The Court held that there was prejudice to the plaintiffs who were denied due process and an opportunity to be heard prior to entry of the Sale Order in the lightning quick bankruptcy process.

The Second Circuit’s ruling means that sale orders in bankruptcy cases may not necessarily cut off successor liability claims against purchasers of assets where there is inadequate notice to parties holding claims that existed at the time the sale was approved.

It is unclear what impact, if any, the Second Circuit's decision will have. On the one hand, the ruling may have a chilling effect upon section 363 bankruptcy sales, which have become common over the past decade. Buyers of assets want certainty that claims of the bankrupt company cannot be pursued against them. On the other hand, the GM decision may be the exception, rather than the rule, based upon the unique circumstances surrounding the GM bankruptcy and the financial backing by the federal government. The transformation from Old GM to New GM was a form over substance transaction.

Buyers of assets in bankruptcy involving automotive companies -- where product liability claims are common -- cannot simply rely on the sellers to deliver free and clear title through a court order. Buyers of assets in 363 sales should strive to ensure that all potentially impacted parties receive notice of the sale. The parties may also consider setting up special escrow reserves to satisfy any potential claims that may arise after the sale.