Bloomberg BNA

BNA's
Bankruptcy Law Reporter™

Reproduced with permission from BNA's Bankruptcy Law Reporter, 26 BBLR 1053, 7/31/14. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Successor Liability in the Bankruptcy Context: Check Your Own Ignition Switch!

BY: SEAN BEACH AND ELIZABETH JUSTISON,
YOUNG CONAWAY STARGATT & TAYLOR, LLP

Introduction

On March 27, 2014, certain plaintiffs commenced a class action against General Motors LLC ("New GM") in the United States District Court for the Southern District of California, seeking to hold New GM liable for damages suffered by class members as a result of an ignition switch defect installed in New GM and General Motors Corporation ("Old GM") vehicles that could cause the vehicles' engines to shut off unexpectedly – a defect New GM acknowledges has been linked to 13 deaths.[1] In April 2014, two additional class action complaints were filed in the United States District Court for the Southern District of New York.[2] New GM has already been condemned by federal regulators who fined the automaker $35 million for its "broken" safety practices and could face additional fines from the Justice Department's criminal investigation and investigations by the House and Senate subcommittees, a group of state attorneys general, and the Securities and Exchange Commission.[3] However, certain defenses may be available to New GM in the class action litigation that are unavailable in the governmental investigations – namely, the sale order entered by the United States Bankruptcy Court for the Southern District of New York on July 5, 2009, which included an injunction against successor liability. While any decision in the GM matter will be addressed by courts in the Second Circuit, the recent decision by the United States Court of Appeals for the Third Circuit, *Emoral, Inc. v. Diacetyl (In re Emoral, Inc.)*, 2014 BL 18612, 740 F.3d 875 (3d Cir. 2014), is illuminating as to how courts may consider the issues.

The Ignition Switch Defect

On February 7, 2014, GM first notified the National Highway Traffic Safety Administration of the existence of ignition switch defects in the 2005-2007 model year Chevrolet Cobalt and 2007 Pontiac G5 vehicles.[4] On February 24, 2014, GM amended this letter to include a "chronology of principal events that were the basis for the determination that the defect related to motor vehicle safety."[5] The first event in the chronology occurred in 2004 when "GM learned of at least one incident in which a Cobalt lost engine power because the key moved out of the 'run' position when the driver inadvertently contacted the key or steering column," but, after considering "the lead time required, cost, and effectiveness" of various solutions, the inquiry "was

Sean Beach is a partner in the Business Reorganization and Restructuring Department of Young Conaway Stargatt & Taylor, LLP. Elizabeth Justison is an associate in the group.

[1] Am. Compl. ¶¶ 1, 21, 104, *Groman v. General Motors LLC*, No. 14-01929 (Bankr. S.D.N.Y. May 22, 2014). *See also* Mathew L. Wald & Danielle Ivory, *G.M. Is Fined Over Safety and Called a Lawbreaker*, N.Y. TIMES (May 16, 2014), http://www.nytimes.com/2014/05/17/business/us-fines-general-motors-35-million-for-lapses-on-ignition-switch-defect.html

[2] Am. Compl. ¶¶ 14-15. The plaintiffs in the three class action complaints collectively brought an action against New GM on April 21, 2014, by filing a complaint in the United States Bankruptcy Court for the Southern District of New York. *See* **Compl. ¶¶ 9-26 (*Groman v. General Motors LLC*, No. 14-01929 (Bankr. S.D.N.Y. Apr. 21, 2014).**

[3] Am. Compl. ¶¶ 1, 21; Wald, *supra* note 1.

[4] Letter from M. Carmen Benavides, Dir., Prod. Investigations and Safety Regulations, General Motors LLC, to Nancy Lewis, Assoc. Admin. for Enforcement, NHTSA (Feb. 7, 2014), available at http://www-odi.nhtsa.dot.gov/acms/cs/jaxrs/download/doc/UCM450012/RCDNN-14V047-1347P.pdf.

[5] Letter from M. Carmen Benavides, Dir., Prod. Investigations and Safety Regulations, General Motors LLC, to Nancy Lewis, Assoc. Admin. for Enforcement, NHTSA (Feb. 25, 2014), available at http://www-odi.nhtsa.dot.gov/acms/cs/jaxrs/download/doc/UCM450732/RCDNN-14V047-7510.pdf.

closed with no action."[6] However, according to a 2001 Problem Resolution Tracking System Report, Old GM may have been aware of the ignition switch defect as early as 2001.[7]

GM later expanded its recall in five subsequent letters to the National Highway Traffic Safety Administration to include nearly 2.5 million vehicles, comprised of the following models: 2005-2010 Chevrolet Cobalt, 2005-2010 Pontiac G5, 2003-2007 Saturn Ion, 2006-2011 Chevrolet HHR, 2005-2006 Pontiac Pursuit (Canada), 2006-2010 Pontiac Solstice, and 2007-2010 Saturn Sky.[8] The owners and lessees of these vehicles received no notice of the ignition switch defect until the February 7, 2014 letter.

The Bankruptcy

On June 1, 2009, Old GM filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the United States District Court for the Southern District of New York.[9] The United States government provided $30.1 billion in debtor in possession financing.[10] On July 5, 2009, the bankruptcy court entered an order approving the sale of substantially all of the assets of Old GM to New GM. Paragraphs 7-10 of the sale order included limitations on successor liability and specifically provided that, with certain exceptions, the purchased assets would be:

> "[f]ree 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" and that all such claim holders would be "forever barred, estopped, and permanently enjoined (with respect to future claims . . . to the fullest extent constitutionally permissible) from asserting against the Purchaser, its successors or assigns, its property, or the Purchased Assets, such persons' or entities' liens, claims, encumbrances, and other interests, including rights or claims based on successor liability."[11]

The bankruptcy court confirmed Old GM's Chapter 11 plan and it became effective on March 31, 2011.[12]

The Complaint

On May 22, 2014, Dr. Steven Groman, Robin DeLuco, Elizabeth Y. Grumet, ABC Flooring, Inc., Marcus Sullivan, Katelyn Saxson, Amy C. Clinton, and Allison C. Clinton amended their April 21, 2014 complaint against New GM, and sought the entry of an order declaring that the sale order entered by the bankruptcy court could not "be used by [New GM] to absolve it of any liability from Plaintiff's Ignition Switch Defect claims."[13] The class action representatives alleged, *inter alia*, that Old GM failed to disclose the existence of any potential claims or liability resulting from the ignition switch defects in any of its filings with the bankruptcy court or during the hearing on the sale motion and that Old GM failed to give notice to all known creditors of the sale or the bar date motion.[14]

It was additionally alleged that Old GM concealed large liabilities, including the ignition switch defect and a post-petition lockup agreement that Old GM allegedly backdated so that it would appear to be a pre-petition transaction because "[i]f Old GM did not submit a viable plan – one that would 'justify an investment of additional taxpayer dollars' and instill 'confidence in [its] long-term prospects for success' – the company would have been forced to cease operations and proceed to an orderly liquidation."[15] The class action representatives argue that these actions (i) deprived plaintiffs who purchased their vehicles prior to the sale of due process, (ii) should preclude and estop New GM from claiming any protections in the sale order given that the same employees of Old GM who concealed the ignition switch defect from the bankruptcy court now work for New GM, and (iii) deprived plaintiffs who purchased vehicles prior to the sale of an opportunity to protect their rights in connection with the sale through no fault, neglect, or carelessness of their own, thereby precluding such plaintiffs from any form of redress if the sale order is enforced.[16]

New GM's Motion

On April 21, 2014, New GM filed a motion to enforce the bankruptcy court's July 5, 2009 sale order and injunction against "litigation in which the plaintiffs seek economic losses against [New] GM relating to an Old GM vehicle or part, including, for example, for the claimed diminution in the vehicle's value, and for loss of use, alternative transportation, child care or lost wages for time spent in seeking prior repairs."[17] New GM expressly excluded from its motion "any litigation involving an accident or incident causing personal injury, loss of life or property damage."[18] According to New GM, "[p]laintiff's express successor liability allegations are simply a violation of this Court's Sale Order and Injunction. But whether or not Plaintiffs' claims expressly allege successor liability, their claims against [New] GM based on Old GM's conduct as essentially successor liability claims cast in a different way and are precluded by that Order."[19]

Notably, pursuant to the June 6, 2009 Amended and Restated Master Sale and Purchase Agreement entered into between Old GM and New GM, New GM expressly

---

[6] *Id.*

[7] *See* 2001 PRTS Report, Issue No. A- 83ZA-81205, (GMHEC000001980-90).

[8] Am. Compl. ¶ 168.

[9] Am. Compl. ¶ 110.

[10] Am. Compl. ¶ 112.

[11] Order (I) Authorizing Sale of Assets Pursuant to Amended and Restated Master Sale and Purchase Agreement with NGMCO, Inc., a U.S. Treasury-Sponsored Purchaser; (II) Authorizing Assumption and Assignment of Certain Executory Contract and Unexpired Leases in Connection with The Sale; And (III) Granting Related Relief ¶¶ 7-10, July 5, 2009, ECF No. 2968. *See also* Am. Compl. ¶ 115.

[12] *See* Findings of Fact, Conclusions of Law, and Order Pursuant to Sections 1129(a) and (b) of the Bankruptcy Code and Rule 3020 of the Federal Rules of Bankruptcy Proceedings Confirming Debtors' Second Amended Joint Chapter 11 Plan, Mar. 29, 2011, ECF No. 9941.

[13] Am. Compl. ¶ 8.

[14] Am. Compl. ¶ ¶ 124-25, 128.

[15] Am. Compl. ¶ ¶ 134-35 (quoting President Barack Obama, Remarks by the President on the American Automotive Industry (Mar. 30, 2009), http://www.whitehouse.gov/the-press-office/remarks-president-american- automotive-industry-33009.

[16] *See* Am. Compl. at ¶ ¶ 172-204.

[17] Motion of General Motors LLC Pursuant to 11 U.S.C. §§ 105 and 363 to Enforce the Court's July 5, 2009 Sale Order and Injunction at 1, *In re Motors Liquidation Co.*, No. 09-50026 (Bankr. S.D.N.Y. April 21, 2014).

[18] Motion at 1.

[19] Motion at 20.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1044-7474

assumed certain defined categories of liability, including, *inter alia*, liability for "post-sale accidents involving Old GM vehicles causing personal injury, loss of life or property damage."[20] It is New GM's position that the assumption of "these limited categories of liabilities was based on the independent judgment of U.S. Treasury officials as to which liabilities, if paid, would best position GM for a successful business turnaround." New GM asserts that a coalition representing Old GM vehicle owners was "[o]ne of the most vigorous groups that objected to Old GM's asset sale motion," and that they unsuccessfully argued that New GM should assume "successor liability claims, all warranty claims (express and implied), economic damages claims based upon defects in Old GM vehicles and parts, and tort claims . . . ."[21] According to New GM, the Court found that New GM would not have consummated the sale absent these exemptions from liability, which lead the court to overrule the objectors on those issues.[22]

On May 12, 2014, the bankruptcy court entered a scheduling order which summarized the "threshold issues to be addressed by the parties," including: (1) "[w]hether procedural due process in connection with the Sale Motion and the Sale Order and Injunction was violated as it relates to the Plaintiffs;" (2) "[i]f procedural due process was violated . . . whether a remedy can or should be fashioned as a result of such violation and, if so, against whom;" (3) [w]hether a fraud on the Court was committed in connection with the Sale Motion and Sale Order and Injunction based on the alleged issues regarding the ignition switch defect;" (4) "[w]hether New GM may voluntarily provide compensation to pre-petition accident victims that allege that their accident was caused by a defective ignition switch, while seeking to enforce the Sale Order and Injunction against claims asserted in the Ignition Switch Actions;" and (5) "[w]hether any or all of the claims asserted in the Ignition Switch Action are claims against the Old GM bankruptcy estate."[23]

In re Emoral

The Third Circuit's recent opinion in *Emoral* may lend some guidance to the bankruptcy court as it determines whether to enforce the sale order and injunction, thereby limiting the successor liability of New GM.

In *Emoral*, the Third Circuit held that a mere continuation theory of successor liability is a general cause of action and therefore property of the estate which can be released and discharged by the bankruptcy court. The litigation in *Emoral* centered around exposure to Diacetyl, "a natural byproduct of fermentation" used to develop a buttery flavor in various products, including microwave popcorn and baked goods.[24] A number of employees exposed to Diacetyl suffered extreme side effects, including serious respiratory illness and, in rare cases, a loss of pulmonary function associated with severe bronchitis leading to the placement of some patients on lung transplant lists.[25] When Aaroma Holdings LLC purchased certain assets and assumed certain liabilities of Emoral, Inc., the parties were aware of these potential claims, and the Asset Purchase Agreement provided that Aaroma was not assuming Emoral's liabilities related to "the Diacetyl Litigation" and that it was not purchasing Emoral's corresponding insurance coverage.[26] At the time of sale, Emoral no longer manufactured Diacetyl and Aaroma never manufactured Diacetyl. Thus, the only cause of action against Aaroma was based on a mere continuation theory of successor liability, as Aaroma could not be held liable for a direct personal injury claim.

When Emoral filed for bankruptcy the following year, disputes arose between the trustee and Aaroma, including the trustee's claim that Emoral's asset sale to Aaroma constituted a fraudulent transfer.[27] These disputes were resolved by a settlement agreement and the trustee agreed to release Aaroma from any "causes of action . . . that are property of the Debtor's Estate."[28] Notably, certain plaintiffs objected to the settlement and ultimately consented based on language in the order indicating that only estate causes of action were being released. Subsequently, certain plaintiffs filed individual complaints against Aaroma in New Jersey state court alleging personal injury and product liability claims under the theory that Aaroma was a "mere continuation" of Emoral and thus, liable.[29]

The Third Circuit, affirming the District Court's ruling, held that, because the plaintiffs' only theory of liability against Aaroma, a third party not alleged to have caused any direct injury to the plaintiffs, is that Aaroma constitutes a "mere continuation" of Emoral, the plaintiffs failed to demonstrate any factual allegations unique to them as compared to other creditors of Emoral.[30] Accordingly, the Third Circuit held that the plaintiffs' successor liability cause of action was general, rather than individualized and, as such, was property of the estate and was released by the trustee in the settlement agreement.[31]

Potential Ramifications

The implications of *Emoral* in the context of a sale under 11 U.S.C. § 363 are unclear. Bankruptcy courts often grant 363 sale orders that include provisions releasing the purchaser from successor liability, like the GM sale order discussed *supra*. An argument could be made that if a bankruptcy court has the authority to enter a settlement approval order permitting the trustee to settle successor liability causes of action, a bankruptcy court should similarly have authority to enter a 363 sale order that releases a purchaser from successor liability causes of action. Despite this similarity, the facts in *Emoral* are distinguishable from the GM litigation.

[20] Motion at 2.
[21] Motion at 3.
[22] Motion at 7.
[23] Notice of Settlement of Scheduling Order Regarding (I) Mot. of General Motors LLC Pursuant to 11 U.S.C. §§ 105 and 363 to Enforce the Court's July 5, 2009 Sale Order and Injunction, (II) Objection Filed by Certain Plaintiffs in Respect Thereto, and (III) Adversary Proceeding No. 14-01929 at 4, *Groman v. General Motors LLC*, No. 14-01929 (Bankr. S.D.N.Y. May 12, 2014).
[24] U.S. Dep't of Labor, Occupational Safety & Health Admin., *Hazard Communication Guidance for Diacetyl and Food Flavorings Containing Diacetyl*, https://www.osha.gov/dsg/guidance/diacetyl-guidance.html
[25] *Id.*
[26] *See In re Emoral, Inc.*, 2014 BL 18612, 740 F.3d 875, 877 (3d Cir. 2014).
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.* at 880.
[31] *Id.* at 882.

In *Emoral*, all of the relevant parties were aware of the Diacetyl litigation at the time of the trustee's settlement agreement with Aaroma whereas the class action representatives argue that Old GM and New GM concealed the ignition switch defect from the U.S. government, who provided their debtor-in-possession financing, the Court, and pre-sale plaintiffs until years following the entry of the sale order, thereby leading to the approval of a sale order which may have been partially based on fraud and which deprived the pre-sale plaintiffs of due process. While the pre-sale plaintiffs may have been aware that some defects could arise in their cars post-confirmation, the level of defects has arguably surpassed any vehicle lessor or buyer's reasonable expectations.

Moreover, despite New GM's argument that certain parties objected to the sale order's limitations on liability and that the court overruled those objections, at that time the court was not aware of the ignition switch defect at all, let alone that it could affect 2.5 million vehicles.

Additionally, the purchaser in *Emoral* never manufactured Diacetyl, and thus the purchaser could only be held liable through a successor liability theory. In contrast, New GM continued to manufacture cars that suffered from the same defect as the cars manufactured by Old GM.

The confirmation of Old GM's plan is another distinction between the GM litigation and *Emoral*. Chapter 11 plans are well-known for their binding effect. Pursuant to 11 U.S.C. § 1141 ''the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holders, or general partner is impaired under the plan and whether or not such creditor, equity security holders, or general partner has accepted the plan.'' Despite this binding effect, a confirmed plan is still required to comply with the due process requirements of the Fifth Amendment, which could lend strength to an argument by the class action plaintiffs that the plan should not be binding on them.

However, consideration should also be given to how the bankruptcy court's decision could affect pre-bankruptcy creditors, who may be relying on the confirmed plan to ensure the value of their settlements.[32] For instance, certain accident victims who experienced injuries pre-bankruptcy negotiated settlement agreements with Old GM that included a grant of stock in New GM.[33] If the class action representatives are permitted to pursue successor liability causes of action against New GM, New GM could be exposed to as much as $10 billion of liability, thereby diluting the settlements reached by pre-bankruptcy creditors.[34]

Conclusion

Thus, while *Emoral* appears to lend support to a release from successor liability in a sale order, the GM litigation raises novel questions of how to balance such a release with an alleged failure to provide due process to potential claimants, particularly where the purchaser of the debtor's assets has the same employees and manufactures the same defective product as the debtor.

---

[32] *See, e.g.*, Mike Spector, *Victim-Compensation Dilemma Hangs Over GM*, Wall St. J. (April 6, 2014, 7:28 PM), http://online.wsj.com/news/articles/SB10001424052702303910404579485633820586134.

[33] *Id.*

[34] *See* Michael I. Krauss, *General Motors: Poster Child for Products Liability*, Forbes (May 19, 2014, 11:47 AM), http://www.forbes.com/sites/michaelkrauss/2014/05/19/general-motors-poster-child-for-products-liability.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1044-7474