



# Inadequate Notice Limits “Free and Clear” Sales in Bankruptcy

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Recently, the United States Court of Appeals for the Second Circuit entered a decision in the General Motors bankruptcy case that found an exception to the “free and clear” language of Section 363(f) of the Bankruptcy Code<sup>2</sup> where adequate notice of the sale order is not provided.<sup>3</sup> However, the exception may not be far reaching due to the “peculiar” facts of the case.

## Factual Background and Lower Court Decision

On June 1, 2009, General Motors Corporation (“Old GM”) filed a petition for bankruptcy under chapter 11 of the Bankruptcy Code. Shortly thereafter, Old GM’s assets were sold to General Motors LLC (“New GM”) pursuant to Section 363 of the Bankruptcy Code. The sale order, among other things, authorized the sale of such assets free and clear of successor liability claims and enjoined all parties from making any such claims against New GM.<sup>4</sup> Despite such protections in the sale order, class action lawsuits were filed against New GM asserting successor liability claims related to faulty ignition switches in vehicles produced by Old GM. The problems with the faulty ignition switches were known to Old GM before such switches were even placed into vehicles, yet Old GM did not work to fix the problems. The successor liability claims essentially fell into three categories: (1) claims based on pre-closing injuries and/or economic losses, both related to the faulty ignition switches and otherwise (the “Pre-Closing Claims”); (2) claims based on post-closing injuries related to the faulty ignition switches of individuals who purchased a General Motors vehicle post-closing (the “Used Car Claims”); and (3) claims based on New GM’s wrongful post-closing conduct of concealing the faulty ignition switch problems (the “Independent Claims”).

The United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”) enforced the sale order, enjoining the Pre-Closing Claims and Used Car Claims despite the lack of notice of the sale order received by the claimants<sup>5</sup> and concluding that any such claims asserted

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<sup>2</sup> 11 U.S.C. §§ 101, *et seq.*

<sup>3</sup> *Elliott v. Gen. Motors LLC (In the Matter of Motors Liquidation Co.)*, 2016 WL 3766237 (2d Cir. July 13, 2016).

<sup>4</sup> Certain claims were excluded from the free and clear provision, including post-closing personal injury claims, repairs, and Lemon Law compliance.

<sup>5</sup> The sale order required direct mail notice be given to “all parties who are known to have asserted any lien, claim, encumbrance, or interest in or on [the to-be-sold] assets.” Old GM’s awareness of the faulty ignition switches meant that claimants asserting successor liability claims related to the faulty ignition switches were entitled to actual notice of the sale order and incorporated injunction. The Bankruptcy Court determined that the lack of notice did not prejudice the claimants, except for claimants with Independent Claims, because the Bankruptcy Court would have entered the sale order even if the claimants had notice and objected to the sale order.

against the liquidating trust for Old GM were equitably moot given that the plan had been substantially consummated with all relevant claim bar dates having long since passed. The Bankruptcy Court certified the judgment for direct appeal to the Second Circuit.

### Second Circuit Holding

The Second Circuit affirmed as to the Bankruptcy Court's decision to not enforce the sale order as to the Independent Claims; reversed the decision as to the Pre-Closing Claims related to the faulty ignition switches and Used Car Claims; vacated the decision as to the Pre-Closing Claims not related to the faulty ignition switches; and vacated the decision as to the equitable mootness holding.<sup>6</sup>

In addressing the scope of the "free and clear" language of Section 363(f) of the Bankruptcy Code, the Second Circuit held that:

[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.

The Second Circuit found that the Pre-Closing Claims were covered by the sale order. The Independent Claims clearly did not fall within the sale order because they were based on post-closing conduct. The Used Car Claims did not fall within the sale order because the purchases occurred post-closing and therefore the claimants did not have the requisite contact or relationship with Old GM to be covered by the sale order.

Even though the Pre-Closing Claims were covered by the sale order, the Second Circuit found that such claimants were entitled to actual notice, not the publication notice that they received, because Old GM knew or reasonably should have known about the faulty ignition switches prior to the bankruptcy. The Second Circuit noted that the contact information for these claimants was easily obtainable because federal law required Old GM to maintain records of the first owners of all of its vehicles. The Second Circuit further found that the insufficient notice prejudiced the holders of Pre-Closing Claims because it was not clear that the key players (Old GM, New GM, and the United States Department of the Treasury (the "Treasury Department"), among others) would not have made concessions for those claimants to push the sale through, particularly given the focus on consumer confidence throughout the bankruptcy case, the involvement of the Treasury Department, and the significant financial and business issues associated with the sale.

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<sup>6</sup> The Second Circuit vacated the equitable mootness portion of the Bankruptcy Court's decision as advisory because the claims were being asserted against New GM, not against the liquidating trust, and therefore the plan was not implicated and mootness was not relevant.

## Effect of Holding

The *Elliott* decision was based on “peculiar” facts, as the Second Circuit noted, with the involvement of the Treasury Department and even the President.<sup>7</sup> Accordingly, the holding is likely to be relatively limited to the facts of the case. Further, it is likely not applicable where the debtor is not reasonably aware of the defects or other issues that would result in future claims. However, where claimants are reasonably known to the bankruptcy estate, as was the case here, actual notice should be given so that the “free and clear” language may apply as broadly as possible.

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<sup>7</sup> Prior to the bankruptcy filing, President Obama had reassured the public that the United States Government would back the warranties for Chrysler and General Motors brand cars.