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BANKRUPTCY AND RECOVERY OF TORT DAMAGES

GEORGE W. KUNEY*

> The apprehension that bankruptcy will become a convenient expedient for avoiding the successorship doctrine is not well founded. The adverse consequences of bankruptcies involving displacement of management, creditor control and liquidation hardly support the argument that [businesses] will use bankruptcy to avoid their responsibilities . . . .[1]
>
> —Don't you believe it![2]

Torts and bankruptcy go hand in hand, at least if the liability is large or endemic enough. What happens when tort liability and bankruptcy intersect may shock you. Asbestos presents only one of the myriad examples of mass tort litigation interrupted by bankruptcy.[3] Other examples include birth control devices,[4] breast implants,[5] and plumbing products.[6]

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1. Rubinstein v. Alaska Pac. Consortium (*In re* New England Fish Co.), 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

2. Author.

3. *See generally* Jack B. Weinstein, *Compensation for Mass Private Delicts: Evolving Roles of Administrative, Criminal, and Tort Law*, 2001 U. ILL. L. REV. 947 (discussing the range of mass tort litigation).

4. *See, e.g., In re* A.H. Robins Co., 89 B.R. 555, 557-58 (E.D. Va. 1988) (summarizing events precipitating the Chapter 11 case of the manufacturer of the "Dalkon Shield").

5. *See, e.g., Dow Corning Corporation Chapter 11 Information, at* http://www.implantclaims.com (last visited Jan. 12, 2004) (providing general information regarding Dow Corning silicone breast implants and ongoing bankruptcy proceedings).

6. *See, e.g.,* Anderson v. Hoechst Celanese Corp. (*In re* U.S. Brass Corp.), 173 B.R. 1000, 1003 (Bankr. E.D. Tex. 1994) (summarizing events precipitating the Chapter 11 filing

What brings these fields of law together are the plaintiffs' desire to recover something after establishing liability and the defendants' desire to avoid payment of tort claims by liquidating assets that can be used to generate future cash flows. Furthermore, potential defendants may be able to block suits or liability entirely, as a legal or practical matter, by use of bankruptcy as a peremptory device before others are generally aware of the potential liability.

Tort and bankruptcy law collide in at least three key areas with which torts attorneys should be familiar: (i) the distinctions that are drawn between existing, yet contingent, claims and future claims—and the implications of these distinctions;[7] (ii) sales of assets free and clear of claims and interests—with and without a plan of reorganization;[8] and (iii) the effect of a company's addition of entity coverage to its directors' and officers' liability policy on a judgment creditor's ability to recover on the policy when the company files for relief under the Bankruptcy Code ("the Bankruptcy Code" or "the Code").[9] This Article seeks to inform the reader on these issues and to suggest how these bankruptcy principles impact upon recovery of tort damages.

I. EXISTING CONTINGENT CLAIMS VERSUS FUTURE CLAIMS

In a Chapter 11 case,[10] confirmation of a plan of reorganization discharges a debtor's liability for "any debt that arose before the date of such confirmation" whether or not the claim is allowed or slated to receive any distributions under the plan.[11] Similarly, in a Chapter 7 case the discharge order bars further pursuit or recovery of "all debts that arose before the date of the order for relief" whether or not the claim in question receives any distributions in the Chapter 7 case.[12] Therefore, understanding when a debt arises is critical for torts attorneys; it determines whether the debt can be discharged and rendered unenforceable through bankruptcy. Unfortunately, the analysis in all but the simple case is not always clear.

As with most bankruptcy analyses, working through the effects of the statute's definition sections is crucial. The word "debt"—what debtors are discharged of through bankruptcy proceedings—is defined as "liability on a

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of the manufacturer of polybutylene pipes).

7. *See* discussion *infra* Part I.

8. *See* discussion *infra* Part II.

9. *See* discussion *infra* Part III.

10. Chapters 7 and 11 are analyzed in this section of the Article because they are the chapters under which business debtors are likely to seek protection. The analysis is largely the same under Chapters 9, 12, and 13, where relief is provided for municipalities, family farmers, and individuals with regular income; however, the analysis under those chapters is beyond the scope of this Article.

11. 11 U.S.C. § 1141(d)(1)(A) (2000).

12. 11 U.S.C. § 727(b).

claim,"[13] and "the meanings of 'debt' and 'claim' [are] coextensive."[14] The question then arises: What is a "claim"? The Code defines the term very broadly as:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach or performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.[15]

In other words, a claim encompasses any liability or potential liability other than one for a purely equitable remedy for which no substitute right to payment exists should the debtor avoid enforcement of the equitable remedy.[16] Tort liability generally meets this definition and is a type of claim under the Code.

The next level of the analysis is to understand when a claim *arises* for purposes of federal bankruptcy law. The answer is not found by looking to state law, as is the case with other bankruptcy-related property questions.[17] Rather, bankruptcy law governs the determination of when a claim arises, and "'not . . . the particular state or non Code federal law giving rise to the claim.'"[18]

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13. 11 U.S.C. § 101(12).

14. Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 558 (1990), *quoted in* Am. Law Ctr. PC v. Stanley (*In re* Jastrem), 253 F.3d 438, 442 (9th Cir. 2001).

15. 11 U.S.C. § 101(5).

16. An example of a nonclaim would be the debtor's "liability" for nonperformance of a mandatory injunction when ordering payment of damages for such nonperformance is not an alternative. *See* Ohio v. Kovacs, 469 U.S. 274, 280-83 (1985). Nonclaim liabilities are rare.

17. *See, e.g.*, 11 U.S.C. § 541(a) (defining property of the estate); Butner v. United States, 440 U.S. 48, 54-55 (1979). The *Butner* Court noted:

> Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.
>
> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.

Id. (footnote omitted). Beyond the question of when a claim "arises" is the issue of what claims are non-dischargeable, which generally features fraudulent or other intentional conduct. *See* 11 U.S.C. § 727 (listing non-dischargeable claims). That issue is fairly well defined and is beyond the scope of this Article.

18. Cal. Dep't of Health Servs. v. Jensen (*In re* Jensen), 995 F.2d 925, 930 n.5 (9th Cir. 1993) (quoting Arlene Elgart Mirsky et al., *The Interface Between Bankruptcy and Environmental Laws*, 46 BUS. LAW 623, 651 (1991)); *see* Cool Fuel, Inc. v. Bd. of Equalization (*In re* Cool Fuel, Inc.), 210 F.3d 999, 1006 (9th Cir. 2000) ("Even when a cause of action is

Courts have employed four tests for determining whether a claim arose preconfirmation or pre-petition. Although three of these tests are generally accepted, one has been largely relegated to the dust bin. The "debtor's conduct test" provides that a claim "arises upon the occurrence of the debtor's [pre-petition] conduct that ultimately gave rise to the subsequent cause of action."[19] This test is the most broad and sweeping of the four. All that must occur is the conclusion of the debtor's side of the test. In other words, if the debtor has "pulled the trigger," the claim has arisen; it is not important whether the tort victim has suffered the injury that will result, or, if the injury has been suffered, whether she even knows that she has been damaged. When discussing discharge of claims, some view this test as raising due process problems. How can the involuntary creditors (tort victims) receive notice and have an opportunity to be heard if they cannot be identified because they have not yet been, and may never be, injured? In certain cases, data may exist to allow some tort victims overly broad notice—all asbestos workers and all asbestos customers of a particular company for example. However, little exists in the way of a practical solution in the products liability context for the problem of the subsequent purchaser (i.e., the person who purchases the defective product from the original purchaser and is then injured by that product after the manufacturer's bankruptcy case has commenced or closed). Lack of a practical solution to this problem led to development of both the "relationship" and the "fair contemplation" tests to define when a claim arises.

The "'relationship' or '*Piper*' test . . . requires either a pre-petition or pre-confirmation relationship, 'such as a contact . . . between the debtor's pre-petition conduct and the claimant.'"[20] Under the "fair contemplation" test, a claim arises pre-petition if it is "'based on pre-petition conduct [and] can be fairly contemplated by the parties at the time of [d]ebtors' bankruptcy.'"[21] When a claim is based on pre-petition tortious conduct that arises out of a pre-petition relationship between the claimant and the debtor, courts have recognized that the debtor conduct, relationship, and fair contemplation tests are all satisfied.[22] Under these circumstances, due process concerns are at least ameliorated, if not solved. If a relationship exists or if the fair contemplation test is met (one is hard pressed to imagine a case where one of these tests would be met and the other would not), potential creditors may be identified

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based on state law, 'the question of when a [claim] arises under the bankruptcy code is governed by federal law.'" (alteration in original) (quoting Siegel v. Fed. Home Loan Mortgage Corp., 143 F.3d 525, 532 (9th Cir. 1998))).

19. Hexcel Corp. v. Stepan Co. (*In re* Hexcel Corp.), 239 B.R. 564, 568 (N.D. Cal. 1999).

20. *Id.* at 567 (quoting Epstein v. Official Comm. of Unsecured Creditors of the Estate of Piper Aircraft Corp. (*In re* Piper Aircraft, Corp.), 58 F.3d 1573, 1577 (11th Cir. 1995)).

21. *Jensen*, 995 F.2d at 930 (quoting *In re* Nat'l Gypsum Co., 139 B.R. 397, 409 (N.D. Tex. 1992)).

22. *See, e.g.*, Rubinstein v. Alaska Pac. Consortium (*In re* New England Fish Co.), 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

from available lists of employees, current and past customers, and vendors, which can be used as a starting point for providing notice. Further, the traditional means of providing actual, directed notice (such as by mail) may be supplemented through constructive notice by publication in papers of record in areas suggested by the otherwise available lists of persons exposed to the product (e.g., employees, customers, and vendors). Of course, in these circumstances, subsequent purchasers that may someday hold future claims are not included in the definition of "claim"; therefore, their claims are not discharged and cannot be stripped from the debtor's assets—if they attach to those assets—under the Bankruptcy Code's sale or vesting free-and-clear powers.[23]

A fourth test, the "state-law accrual" or "right to payment" test, "provides that a claim only 'arises' once the claimant has the right to obtain payment."[24] The Third Circuit applied this test in *Avellino & Bienes v. M. Frenville Co.*;[25] however, most courts have criticized and rejected it as inconsistent with the broad definition of "claim" in § 101(5).[26]

What does this mean for the torts attorney? Because of the Code's broad definition of claim, the near universal criticism of the state-law accrual test, and the concomitant adoption of the debtor's conduct, relationship, and fair contemplation tests, most tort liability other than so-called "future claims" will be classified as claims or debts that can be eliminated through the bankruptcy discharge.

Where the injury resulting from the tort is complete, employing this analysis provides little difficulty, even if its results are disappointing for both the tort victim and counsel. In such a case, the tort liability will be classified as a general unsecured claim and treated ratably with other, similarly situated creditors.[27]

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23. *See* 11 U.S.C. §§ 363(f), 1141(b)-(c) (2000).

24. *Hexcel*, 239 B.R. at 569 n.5 (citing Avellino & Bienes v. M. Frenville Co. (*In re* M. Frenville Co.), 744 F.2d 332 (3d Cir. 1984)).

25. 744 F.2d 332, 337 (3d Cir. 1984).

26. *See Jensen*, 995 F.2d at 930 ("*Frenville*'s 'right of payment' theory is 'widely criticized' outside the Third Circuit, at least in part because it would appear to excise 'contingent' and 'unmatured' claims from § 101(5)(A)'s list." (citation omitted)); *see, e.g.*, Am. Law Ctr. PC v. Stanley (*In re* Jastrem), 253 F.3d 438, 442 (9th Cir. 2001) (quoting language from *Jensen* in support of its criticism of the right to payment test); *see also* Cool Fuel, Inc. v. Bd. of Equalization (*In re* Cool Fuel, Inc.), 210 F.3d 999, 1006 (9th Cir. 2000) ("It is well-established that a claim is ripe as an allowable claim in a bankruptcy proceeding even if it is a cause of action that has not yet accrued.").

27. Priority in bankruptcy is everything to creditors. The priority scheme, in descending order, may be summarized as follows:

(1) Secured Creditors (up to the value of their collateral less any permissible surcharges), *see* 11 U.S.C. §§ 506(a), 507, 726(a)(1);

(2) Administrative Priority Unsecured Creditors (largely postpetition debtors and the fees and expenses of insolvency professionals involved in the case as allowed by the bankruptcy

Where, however, the injury resulting from the tort is *not* complete—as in the case of future claims—difficulties exist. These situations arise when the debtor has completed its tortious conduct, and the tort victim has not yet sustained damage or discovered that she has sustained damage. The most common example, as noted above, is products liability. The law in this area is unsettled and is best considered on a case-by-case basis in which the particular facts may indicate whether a future claims representative, a channeling injunction, or some other mechanism is appropriate, or whether the claims must remain unaddressed and undischarged.

Under the apparently dominant view,[28] a future successor liability claim is not an *in rem* claim or interest.[29] Rather, successor liability is based more

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court), *see* §§ 503, 507, 726(a)(1);

(3) Other Priority Creditors (including workers' claims (subject to dollar limitations), special interest group claims (such as those of grain farmers, fishermen, consumers that made prepayments or deposits, and spouses for alimony, maintenance, or support), certain taxes and duties, and FDIC claims), *see* §§ 507(a), 726(a)(1);

(4) General Unsecured Creditors (including those holding tort judgments or tort claims that arose pre-petition under the pertinent test), *see* § 726(a)(2);

(5) Subordinated Debt (subordinated either by contract or by operation of law or court order), *see* § 726(a)(3)-(4); and

(6) Equity Holder Interests (stock, partnership interests, limited liability company membership interests, etc.), *see* § 726(a)(6).

It is important for plaintiffs' lawyers to note how low general unsecured debt falls on the priority ladder and the low distributions that generally are made on account of that debt.

28. An alternative theory, relying upon property law concepts, exists and has been discussed in academic and bankruptcy reform circles. *See* J. Maxwell Tucker, *The Clash of Successor Liability Principles, Reorganization Law, and the Just Demand that Relief Be Afforded Unknown and Unknowable Claimants*, 12 BANKR. DEV. J. 1, 34 n.177 (1995), *citing* David Gray Carlson, *Successor Liability in Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created by Running Covenants, Products Liability, and Toxic-Waste Cleanup*, 50 LAW & CONTEMP. PROBS. 119, 131, 145-49 (1987). However, this theory has not met with much acceptance in case law, as only one reported opinion has apparently mentioned it. *See* Conway v. White Trucks, 692 F. Supp. 442, 455 n.9 (M.D. Pa. 1988) (summarizing Professor Carlson's position to be "that [§ 363(f)(5)] should be read to permit the foreclosure of future claimants from proceeding against successor corporations where a fund is created to which the future Plaintiffs' ratable share of cash proceeds would be paid"). Under this "property" approach to successor liability, the bankruptcy court can use § 363(f) to scrape successor liability claims off the debtor's property like barnacles from the hull of a ship—at least under certain conditions, such as when a trust is created from the proceeds of sale.

29. Fairchild Aircraft Inc. v. Cambell (*In re* Fairchild Aircraft Corp.), 184 B.R. 910, 920 (Bankr. W.D. Tex. 1995) ("[W]hile successor liability may give a party an alternative entity from whom to recover, the doctrine does not convert the claim into an *in rem* action running against the property being sold."), *vacated by* 220 B.R. 909 (Bankr. W.D. Tex. 1998); *In re* Correct Mfg. Corp., 167 B.R. 458, 460 (Bankr. S.D. Ohio 1994) (stating that unless the *Piper Aircraft* "prepetition relationship" test is met, there is "no claim against the estate under the definition of claim codified in 11 U.S.C. § 101(5)").

on tort or conduct notions, such that no claim arises until the tort occurs.[30] Thus, in the case of future products liability claims, there is no claim to sell free and clear of at the time of the sale. The claim arises later, in the hands of the successor; therefore, a previous § 363(f) order could not have affected it.[31]

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30. *See* Fogel v. Zell, 221 F.3d 955, 960 (7th Cir. 2000) ("The products-liability tort occurs when the defect in the design or manufacture of the product causes a harm, and [that did not] happen to Denver until the defective pipes burst.").

31. Mooney Aircraft Corp. v. Foster (*In re* Mooney Aircraft, Inc.), 730 F.2d 367, 375 (5th Cir. 1984) ("The [plaintiffs] did not even have a claim at the time of the bankruptcy court's order of sale. There was no property right to be deprived; by the same token, there was no claim to be divested." (footnote omitted)), *quoted in* Am. Living Sys. v. Bonapfel (*In re* All Am. of Ashburn, Inc.), 56 B.R. 186, 189 (Bankr. N.D. Ga. 1986). Similarly, in rejecting an argument that notice by publication was sufficient to bar tort victim postpetition claims based on injuries arising prior to plan confirmation, the Bankruptcy Court for the Northern District of Illinois stated:

> [T]he argument implies that the *uninjured* persons who wish to protect themselves in event of future injuries have the burden of monitoring national financial papers . . . to read notices about businesses they have no claims against because they are on notice of claim bar dates affecting any future injuries caused by such companies. Franz Kafka would have been able to accept such a legal principle in one of his stories; the Bankruptcy Code and the Fifth Amendment to the United States Constitution cannot.

Pettibone Corp. v. Payne (*In re* Pettibone Corp.), 151 B.R. 166, 172 (Bankr. N.D. Ill. 1993). Cases addressing the issue routinely hold that claims are not barred or discharged when they arise after a sale or confirmation order and are held by claimants that neither had a pre-order relationship with the debtor nor received any meaningful notice of the proceedings. *See* Hexcel Corp. v. Stepan Co. (*In re* Hexcel Corp.), 239 B.R. 564, 570 (N.D. Cal. 1999) (holding that a post-confirmation claim against the debtor for contribution in a toxic tort case was not "reasonably contemplate[d]" by the parties preconfirmation and, thus, was not discharged via the confirmed plan); Schwinn Cycling & Fitness Inc. v. Benonis, 217 B.R. 790, 795-96 (N.D. Ill. 1997) (concluding that a post-confirmation products liability claim was not discharged by the confirmed plan and was not extinguished through the sale free and clear); *see also* Epstein v. Official Comm. of Undersecured Creditors of the Estate of Piper Aircraft Corp. (*In re* Piper Aircraft, Corp.), 58 F.3d 1573, 1577 (11th Cir. 1995) (recognizing that possible future products liability claimants with no preconfirmation relationship with the debtor's product do not hold claims under § 101(5) and cannot participate in the bankruptcy proceedings via an appointed representative); W. Auto Supply Co. v. Savage Arms, Inc. (*In re* Savage Indus., Inc.), 43 F.3d 714, 720 n.9 (1st Cir. 1994) (noting that an order approving the sale of substantially all of the debtor's assets under § 363 is "the functional equivalent" of an order confirming a plan of reorganization); Kewanee Boiler Corp. v. Smith (*In re* Kewanee Boiler Corp.), 198 B.R. 519, 526, 540-41 (Bankr. N.D. Ill. 1996) (holding that a successor liability claim arising from the post-confirmation explosion of a boiler manufactured by the debtor was not barred under § 524(a)(2)). This recognition that some successor liability claims have yet to arise is also inconsistent with the notion that successor liability is an existing *in rem* interest at the time of the sale.

II. TRANSFERS OF ASSETS FREE AND CLEAR

The hallmark of much bankruptcy practice is the separation of assets from liabilities.[32] In Chapter 7, the trustee collects and liquidates the debtor's nonexempt assets, then distributes the resulting proceeds to creditors and parties in interest in order of priority. In a classic Chapter 11 case,[33] the debtor deploys its assets according to a business model provided for in the plan of reorganization and described in the disclosure statement. The proceeds and product of this deployment are used to make payments to various classes of creditors and parties in interest as provided for in the plan. In each case, the effect of bankruptcy is to stay creditors, collect the debtors' nonexempt assets, and distribute the product or proceeds of the assets—whether operated, hypothecated, or sold—to creditors under either the Chapter 7 priority scheme or one detailed in a plan that meets the requirements of Chapter 11.

The process of separating assets and liabilities is fairly straightforward and relatively inexpensive in the Chapter 7 context—not so in Chapter 11. The road to a confirmed plan can be long, hard, and expensive; the Chapter 11 process provides myriad opportunities for creditors and other parties in interest to seek relief from or against a debtor or to object to the debtor's proposals, operating decisions, business plans, and the plan of reorganization itself.[34] Nonetheless, the ability to separate assets from liabilities and retain control over the assets or their proceeds is very alluring to potential debtor businesses and those who control them. That is the promise of Chapter 11.

As a result of the high cost of realizing the benefits of Chapter 11 through the classic plan-based reorganization, insolvency professionals have developed and the courts have increasingly blessed the nonplan sale of a business in Chapter 11 under 11 U.S.C. § 363.[35] Nonplan sales are accomplished through motion practice, rather than the lengthy and expensive multistep plan

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32. *See generally* Kuney, *Misinterpretations I*, *supra* note * (discussing separation strategy); *cf.* Kuney, *Misinterpretations II*, *supra* note * (discussing separation strategy in the real estate context). *See generally* George W. Kuney, *Let's Make it Official: Adding an Explicit Pre-Plan Sale Process as an Alternative Exit from Chapter 11*, 40 HOUS. L. REV. (forthcoming 2004) (on file with the Tennessee Law Review) (proposing a scheme for uniform regulation of nonplan sales); George W. Kuney, *Selling a Business in Bankruptcy Without a Plan of Reorganization*, 18 CAL. BUS. L. PRAC. 57 (2003) (discussing the rapid growth of bankruptcy courts as a forum for the nonplan sale of business assets free and clear of liabilities).

33. A "classic Chapter 11 case," as the term is used here, denotes a case focused on proposing and confirming a plan of reorganization. This type of case was the model for which Chapter 11 was drafted, but the cost and delay attendant upon the process have made the successful classic Chapter 11 case rare. *See* Kuney, *Misinterpretations I*, *supra* note *, at 242 n.30.

34. *See id.* (describing evolution of the Chapter 11 sale free-and-clear process in response to the high cost and delay of reorganization by plan).

35. *See* Kuney, *Misinterpretations I*, *supra* note *, at 238-44 (describing the sale out-of-the-ordinary-cause-of-business and free-and-clear sales processes).

process.[36] This process allows a debtor to sell its business to an entity that pays for it with cash or other consideration,[37] such as a promissory note secured by the assets sold or some form of a participating contingent interest in the business's future operation.[38] Finally, through expansive interpretation of § 363(f), the sale is made free and clear of *claims* and interests, cutting off the rights of the debtor's creditors that would otherwise exist under state law, including rights of recovery under the doctrine of successor liability. *In re Trans World Airlines*,[39] involving the Chapter 11 bankruptcy and § 363(f) sale of former airline great Trans World Airlines (TWA) illustrates the effect that this practice can have on plaintiffs and their counsel.

Before filing for relief under the Bankruptcy Code, TWA had been the subject of two sets of claims involving the Equal Employment Opportunity Commission (EEOC): the "Travel Voucher Program Claims" and the other "EEOC Claims."[40] Underlying the Travel Voucher Program Claims was a suit filed in 1977—and later certified as a class action—by a female flight attendant for sex discrimination in violation of Title VII of the Civil Rights Act of 1964.[41] The suit was based upon TWA's practice of "placing female flight attendants on [maternity] leave immediately upon becoming pregnant" regardless of their individual ability to perform their job functions.[42] The class action was settled in exchange for system-wide travel vouchers that could be used by the class members or their family at any time during the class members' lifetime.[43] The other EEOC Claims were not fully adjudicated or

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36. *See* 11 U.S.C. §§ 1121-29 (2000) (detailing the plan, disclosure statement, and confirmation process).

37. *See* 11 U.S.C. § 363.

38. For example, in 2001, Enron Corporation conducted a § 363 sale of its energy trading businesses—the heart of its business—to UBS Warburg entirely in exchange for a participating contingent interest in future profits. *See* Alan Clendenning, *Enron Power Trading Division Buyer to Share Profits* (Jan. 14, 2002), *available at* http://www.boston.com/news/daily/14/enron_011402.htm.

39. 322 F.3d 283 (3d Cir. 2003).

40. *Id.* at 285.

41. *Id.*

42. *Id.*

43. *Id.* In explaining why the voucher settlement—reached in 1995—was still relevant some twenty-five or more years after suit was originally filed, the court stated that "[m]ost flight attendants, as was their prerogative, elected to save the vouchers for long trips to be taken after retirement when they had more time to travel and would receive more favorable tax consequences for use of the vouchers." *Id.* Interestingly, this statement is not necessary for the holding or the remainder of the opinion unless it is read as a justification for the court's action in effectively denying the flight attendants the benefit of their prior bargain. If so, the implication may be that the flight attendants involved had over eight years since the settlement to use their vouchers and had, instead, made a greedy bet by deferring their use which, due to the outcome of the case, they lost.

settled and included claims for "various violations of several federal employment discrimination statutes."[44]

During TWA's bankruptcy case, substantially all of its operating assets were sold to American Airlines' parent company, AMR, free and clear of "all asserted or unasserted, known or unknown, employment related claims, payroll taxes, employee contracts, employee seniority accrued while employed with [TWA or its affiliates] and successorship liability accrued up to the date of the closing of such sale."[45] Further, the sale order enjoined anyone "from taking any action against [AMR or its affiliates] including, without limitation, [the AMR acquisition subsidiary], to recover any claim which such Person had solely against [TWA or its affiliates]."[46]

In considering whether the sale, conducted under § 363(f) of the Bankruptcy Code, could bar claims, including both sets of EEOC claims, the Third Circuit noted that the free-and-clear-of-interests process had been narrowly interpreted to mean free and clear of *in rem* interests in the past, but that the trend was toward "a more expansive [interpretation that] 'encompasses other obligations that may flow from ownership of the property [sold].'"[47] The court's remaining analysis smacked strongly of the doctrine of "bankruptcy *uber allis*."[48] Importantly, however, the court concluded that the sale free-and-clear power, emanating from both § 363(f) and a "'grant[] by implication,'"[49] includes the power to sell free and clear of claims such as those at issue in *Trans World Airlines*, which would normally accrue against the purchaser of the assets in question under the doctrine of successor liability.[50] Therefore, the EEOC claims were stripped from the assets and for all intents and purposes eliminated.

The following subparts of this Article describe in more detail the procedure and conditions for a sale free and clear of claims and interests that have become at least as important in Chapter 11 practice as the plan confirmation process. The key differences between the "preplan sale free and clear" and "plan confirmation" processes are that the sale process (i) occurs much faster, (ii) has fewer points of objection or leverage for unsecured creditors and other low-priority parties in interest, and (iii) does not afford these parties an opportunity to bargain for the amount of any eventual

44. *Id.* at 286.

45. *Id.* at 286-87.

46. *Id.* at 287.

47. *Id.* at 288-89 (quoting 3 COLLIER ON BANKRUPTCY ¶ 363.06[1] (Lawrence P. King ed., 15th ed. rev. 1998)).

48. "Bankruptcy Over All"—a rule of decision that can be applied to easily resolve all collisions of bankruptcy law and other bodies of law, although one may question whether the rule of decision is right in such circumstances.

49. *Trans World Airlines*, 322 F.3d at 292 (quoting Van Huffel v. Harkelrode, 284 U.S. 225, 227 (1991)).

50. *Id.* at 293.

distribution on unsecured claims. Generally, all of these effects are negative from the perspective of a tort victim or lawyer.

A. Sections 363(f) and 1141(c)[51]

Bankruptcy Code § 363(f) permits a trustee or debtor in possession[52] to sell property of the estate free and clear of *interests* in the property if any one of five conditions is met.[53] The section provides:

> The trustee may sell property under subsection (b) or (c) of this section *free and clear of any interest in such property* of an entity other than the estate, only if—
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[54]

Although § 363 can be used to implement a confirmed plan, it can also be used on a freestanding basis to authorize a preplan sale free and clear through a trustee's or debtor in possession's motion to sell.[55] In addition, Bankruptcy Code § 1141(c) can explicitly render assets free and clear of *claims and interests* through the process of plan confirmation, consummation, and postconfirmation vesting:[56]

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51. The text and footnotes of this subpart are largely derived from Kuney, *Misinterpretations I, supra* note *, at 238-44.

52. *See* 11 U.S.C. § 902(5) (2000) (defining "trustee" generally to mean "debtor" in Chapter 9 cases); § 1107(a) (granting a Chapter 11 debtor in possession the rights, powers, and duties otherwise provided for the trustee under the Bankruptcy Code); § 1203 (granting trustee rights and powers to the Chapter 12 debtor); § 1303 (granting trustee rights and powers to the Chapter 13 debtor).

53. 11 U.S.C. § 363(f) (stating that the sale free-and-clear power may be used "only if" one of five express conditions is met).

54. 11 U.S.C. § 363(f) (emphasis added).

55. FED. R. BANKR. P. 4001 (setting forth motion practice procedure for, *inter alia,* sales free and clear). Absent an objection, and assuming that the pleadings provide an evidentiary basis to support the sale, there is not even the need for a hearing. 11 U.S.C. § 102(1) (defining the phrase "after notice and a hearing" as authorizing court action if notice is given properly, and there is either no request for or no time for a hearing).

56. *See* 11 U.S.C. § 1123(a)(5) (allowing the plan to provide for the sale or transfer of property); § 1123(b)(3) (allowing the plan to "provide for the settlement or adjustment of any claim or interest"); § 1123(b)(4) (allowing the plan to "provide for the sale of . . . substantially all of the [assets] of the estate"); § 1141(c) (allowing postconfirmation vesting of property "free

> Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is *free and clear of all claims and interests* of creditors, equity security holders, and of general partners in the debtor.[57]

The postconfirmation vesting power can only be invoked under a confirmed plan.[58]

Perhaps because of the ease of proceeding to sale by motion rather than by confirmed plan of reorganization, § 363(f)'s sale free-and-clear power has been interpreted expansively and extensively[59] while § 1141(c)'s vesting free-and-clear power, which is broader than § 363(f) on its face, has been largely ignored.[60] The sale or vesting free-and-clear powers involve a number of issues, which courts have resolved in ways that could not have been predicted when the statute was enacted in 1979. For example, the term "interest"—the group of things that an asset may be sold or vested free and clear of—is not defined in the Bankruptcy Code,[61] despite detailed definitions for many similar foundational terms.[62] Also, courts have largely ignored the absence of the word "claims" in § 363(f) and the contrast of that section's language with that of § 1141(c), which explicitly speaks of vesting free and clear of *claims and interests* under a confirmed plan.[63] Despite the absence of the word "claims" in § 363(f), preplan sales free and clear of claims are routine.[64]

This judicial treatment, in turn, has led to the practice of today: throwing companies into bankruptcy merely to effect an asset sale of a business or division.[65] Moreover, subsequent review of these sales-free-and-clear orders

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and clear of all claims and interests").

57. 11 U.S.C. § 1141(c) (emphasis added). Section 1141(c) complements or enables the portion of § 1123(b) that allows a plan to contain provisions "for the sale of all or substantially all of the property of the estate." § 1123(b)(4).

58. 11 U.S.C. § 1141(c).

59. *See* Kuney, *Misinterpretations I*, *supra* note *, at 241.

60. *See* Kuney, *Misinterpretations II*, *supra* note *, at 293.

61. *See* Folger Adam Sec., Inc. v. Dematteis/MacGregor, JV, 209 F.3d 252, 257 (3d Cir. 2000) ("The term 'any interest,' as used in section 363(f), is not defined anywhere in the Bankruptcy Code."); Minstar, Inc. v. Plastech Research, Inc. (*In re* Arctic Enters., Inc.), 68 B.R. 71, 78-80 (D. Minn. 1986) (construing "interests" under § 1141(c) to include liens).

62. *See* 11 U.S.C. § 101 (defining over 55 basic terms, but not "interest").

63. *See, e.g.*, *In re* Trans World Airlines, Inc., 322 F.3d 283, 293 (3d Cir. 2003) (holding that nonplan sale of TWA's assets was free and clear of employment discrimination and travel voucher *claims* connected to or arising out of those assets).

64. Although a treatise prepared by perhaps the preeminent corporate restructuring firm describes the practice and notes the lack of express language in § 363(f) to authorize sales free and clear of claims, it glosses over the matter in a footnote that draws upon historical equitable powers and policy arguments. *See* 1 WEIL, GOTSHAL & MANGES LLP, REORGANIZING FAILING BUSINESSES 11-23 & n.80 (Supp. 2003).

65. *See, e.g.*, Nick Wingfield, *Napster Files for Chapter 11 Shelter*, WALL ST. J., June 4,

is largely squelched because § 363(m) moots most appeals[66] before they can be briefed and considered on even the first rung of the appellate ladder.[67]

The following subparts discuss the existing precedent regarding § 363(f) and the interpretation of the word "interest" in that provision to include "claims"—making it possible for a business to be sold as a going concern free and clear of the claims of its tort victims and other creditors.

B. The Conditions for Sales Free and Clear[68]

1. Sections 363(f)(1), (2), (3)—Unsurprising Conditions Allowing Sale Free and Clear

The first three alternative preconditions for preplan sales free and clear under § 363(f) are not surprising. Under § 363(f)(1), if "applicable

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2002, at B6 ("Napster Inc., in an expected move, filed for Chapter 11 bankruptcy protection as prelude to a proposed sale of the company's assets . . . .").

66. Section 363(m) of the Bankruptcy Code provides:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section[, which are implicated in any § 363(f) sale,] of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

11 U.S.C. § 363(m). This provision creates a race to close a transaction as soon after entry of the sale order as possible to prevent any stay from issuing and to moot potential appeals. *See, e.g.*, *In re* Sax, 796 F.2d 994, 997-98 (7th Cir. 1986) (holding that the appellant's failure to obtain a sty of appeal before the bankruptcy sale closed automatically mooted any appeal). Under § 363(m) and current best practice, a sale transaction will close shortly after court approval, and any appeal will be rendered moot, assuming that the court made requisite findings of good faith and did not grant a stay of the order before the closing. *See* Va. Dep't of Med. Assistance Servs. v. Shenandoah Realty Partners, L.P. (*In re* Shenandoah Realty Partners, L.P.), 248 B.R. 505, 510, 516 (W.D. Va. 2000) (discussing the standards for reviewing a request for a stay pending appeal and denying the appellant's motion for stay); *see, e.g.*, Official Comm. of Senior Unsecured Creditors of First RepublicBank Corp. v. First RepublicBank Corp., 106 B.R. 938, 940-41 (N.D. Tex. 1989) (dismissing an appeal from the sale of the debtors' assets, which was consummated the moment the bankruptcy court's sales order became effective, because the appellant did not procure a stay of the order pending appeal, and concluding that "the dog is dead and the appeal is moot"); *see also* FED. R. BANKR. P. 8002 (indicating that orders become final and nonappealable ten days after entry).

67. The appellate ladder for bankruptcy decisions has an extra rung over that of the standard federal civil action. Bankruptcy court decisions are appealed to the district courts or to bankruptcy appellate panels, whose decisions are appealed to the circuit courts of appeals. Finally, resort may be had to the United States Supreme Court for a fourth, albeit discretionary, decision on the matter.

68. The text and footnotes of this subpart are largely derived from Kuney, *Misinterpretations I*, *supra* note *, at 244-51.

nonbankruptcy law permits [the] sale," the Code also permits the sale.[69] Essentially, this provision recognizes that there is no reason to limit pre-existing rights and remedies in a liquidation or reorganization to benefit creditors and parties in interest.[70] Despite the apparent overlap, there may be an advantage to selling assets under § 363(f)(1), rather than under applicable nonbankruptcy law, because § 363(f)(1) is not constrained by the procedures of applicable nonbankruptcy law, which otherwise would be used to justify the sale.[71] Consequently, this simplification may result in savings of both time and money.

Similarly, under § 363(f)(2), if the party asserting the interest consents to the sale free and clear of that interest, the Code permits the sale.[72] There is no reason to bar a consensual transaction that will benefit the estate.

Finally, under § 363(f)(3), a sale free and clear of liens is authorized when it will result in proceeds that exceed the aggregate value of all liens on the property.[73] The liens exist to secure payment; if the payment is made, no liens are needed.

While the first three of the five § 363(f) alternative conditions are fairly straightforward, the last two could not be more different. They address nonconsensual transfers of the highest order and can lead to seemingly bizarre results if left unchecked.

2. Section 363(f)(4)—Sale When the Interest is in Bona Fide Dispute

Although far-reaching, this condition to the sale free-and-clear power

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69. 11 U.S.C. § 363(f)(1).

70. Although the phrase "parties in interest" is used in no less than 106 sections of the Bankruptcy Code and 79 of the Federal Rules of Bankruptcy Procedure, it is not defined in either source.

71. *See* Scherer v. Fed. Nat'l Mortgage Ass'n (*In re* Terrace Chalet Apartments, Ltd.), 159 B.R. 821, 824-25 (N.D. Ill. 1993) (specifying that the notice, manner, and timing of a sale free and clear are provided by Rules 2002(a)(2) and 6004(f)(1) of the Federal Rules of Bankruptcy Procedure, and not by the state foreclosure law used to justify sale).

72. 11 U.S.C. § 363(f)(2). The statute requires actual consent, not "implied consent" based upon a failure to object. *In re* Roberts, 249 B.R. 152 , 155-56 (Bankr. W.D. Mich. 2000) (stating that Congress intended to distinguish between "consent" and "failure to object," as evidenced by the Code's use of the phrase "after notice and a hearing," defined in § 102(1)(B)(i), which authorizes the no-hearing-without-objection-and-request-for-hearing procedure that is pervasive in bankruptcy practice and is colloquially known as "scream or die"). *But see* Citicorp Homeowners Servs., Inc. v. Elliot (*In re* Elliot), 94 B.R. 343, 345-46 (E.D. Pa. 1988) (holding that a party's failure to object is sufficient implied consent to satisfy § 363(f)(2)); Ragosa v. Canzano (*In re* Colarusso), 295 B.R. 166, 175 (B.A.P. 1st Cir. 2003) (finding that the adverse possession claimant's "failure to object to the sale, or to seek adequate protection under § 363(e), and her participation in the sale as a bidder . . . was consent under § 363(f)(2)").

73. 11 U.S.C. § 363(f)(3).

appears easily understood and applied. If the property interest is subject to bona fide dispute[74] by the interested parties, the property can be sold free and clear of that interest,[75] which will generally attach to the proceeds.[76] This provision allows productive assets subject to deadlocking disputes to be transferred to a third party, thereby enabling the assets to remain economically productive, while the original parties continue to litigate or otherwise proceed to resolve their disputes.[77]

Sales under § 363(f)(4) make good sense in the simple case involving economically productive assets. For example, productive agricultural land, a

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74. Although the definition of "bona fide" in this context is less than clear, *see* Cheslock-Bakker & Assocs., Inc. v. Kremer (*In re* Downtown Athletic Club), No. M-47(JSM), 2000 WL 744126, at *4 (S.D.N.Y. June 9, 2000) (indicating that a bona fide dispute requires "'an objective basis for either a factual or legal dispute'" (quoting *In re* Collins, 180 B.R. 447, 452 (Bankr. E.D. Va. 1995))), it is clearly the burden of the moving party, debtor in possession, or trustee to establish that such a dispute exists. *See In re* Octagon Roofing, 123 B.R. 583, 590 (Bankr. N.D. Ill. 1991). In the case of a secured-creditor-versus-debtor dispute it is unnecessary that either party have commenced an adversary proceeding challenging the priority, validity, and extent of the lien at issue. *In re* Oneida Lake Dev., Inc., 114 B.R. 352, 357-58 (Bankr. N.D.N.Y. 1990) (interpreting *In re* Millerburg, 61 B.R. 125, 127-28 (Bankr. E.D. N.C. 1986)).

75. 11 U.S.C. § 363(f)(4). Unlike sales under § 363(f)(2), failure to object to a sale of property under § 363(f)(4) can constitute implied consent to the sale. *In re Elliot*, 94 B.R. at 345-46; Pelican Homestead & Sav. Ass'n v. Wooten (*In re* Gabel), 61 B.R. 661, 667 (Bankr. W.D. La. 1985).

76. Although attachment of the disputed property interest to the proceeds of a sale is the most common form of adequate protection, it is not the only option. *See* 11 U.S.C. § 363(e); *see also* HOUSE COMM. ON THE JUDICIARY BANKRUPTCY LAW REVISION, H.R. REP. NO. 95-595, at 181-83 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6142-43 (accompanying House Bill 8200 and indicating that sales free and clear in bona fide dispute circumstances and notions of adequate protection originated well before enactment of the Code). The mechanism of providing adequate protection is limited only by the imagination of the parties and the court. *Id.*; *see also* 11 U.S.C. § 363(d) ("The trustee may use, sell, or lease property . . . only to the extent not inconsistent with any relief granted under [§ 362(c)-(f)].").

77. Nothing prevents the transferee from being an entity owned or controlled by one of the original parties. For instance, the Code contains no express restriction that prevents one of two entities that assert an ownership interest in property from commencing a Chapter 11 case and forming a separate nondebtor entity to which the property would be sold. *See In re* Gen. Bearing Corp., 136 B.R. 361, 364-67 (Bankr. S.D.N.Y. 1992) (noting that if the debtor's proposed § 363(f) sale to an insider-formed entity was instead part of a plan of reorganization, the sale would be unconfirmable as an "indirect end run around the bankruptcy concepts of absolute priority and new value," but—although denying approval of the sale on other grounds—as a preconfirmation sale, the insider arrangement would not prevent approval of the transaction); *cf. In re* Apex Oil Co., 92 B.R. 847, 869-70 (Bankr. E.D. Mo. 1988) (concluding that the mere affiliation of an insider of the debtor with the proposed sale purchaser is insufficient to show lack of good faith for § 363(b) purposes, and defining good faith as an absence of "'fraud, collusion between the purchaser and other bidders . . . , or an attempt to take grossly unfair advantage of other bidders'" (quoting *In re* Rock Indus. Mach. Corp., 572 F.2d 1195, 1198 (7th Cir. 1978))).

housing development, or an oil field might otherwise lie fallow until a multi-party dispute between co-owners, alleged co-owners, and secured creditors is finally resolved. In the bankruptcy case of an owner of one such asset, a sale free and clear allows the asset to return to productivity, with attendant societal benefits, while the owners' and creditors' interests are adequately protected—generally by being transmuted into an interest in the proceeds of the sale.[78] Assuming something approaching a perfect market for the sale of the asset, the owners are not materially harmed and economic efficiency is served.[79]

Essentially, § 363(f)(4) provides an expeditious method for clearing title to a disputed asset.[80] This process also ensures that *none* of the parties claiming an interest in property subject to the bona fide dispute will *directly*[81] receive the property in question. Their dispute, which may be the precipitating event making resort to bankruptcy relief necessary, can be resolved in due course, but the asset will be transferred beyond the dispute and their reach. Owned by a third party, the asset can return to economic productivity.

Beyond the simple case, however, the § 363(f)(4) power to sell free and clear can lead to bizarre results. Consider the following example: A company closes a new round of financing by issuing publicly traded securities. It receives the proceeds of the transaction, twenty million dollars. One week later, the company releases disappointing information regarding operations, product development, and its inability to obtain needed governmental approval. Immediately, a class action securities fraud suit is filed seeking to rescind the financing and recover the proceeds for the investors. The company denies wrongdoing, stating that the negative news and results were unknown until after the transaction had closed.

The plaintiffs seek a preliminary injunction and temporary restraining order to enjoin the company from using the proceeds of the financing pending resolution of the securities fraud action. However, before the district court can even consider the request for a temporary restraining order, the company files a Chapter 11 petition in another district.[82] Consequently, the original district

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78. *See* 11 U.S.C. § 363(e).

79. *See generally* John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. INST. L. REV. 53 (1995) (reviewing bankruptcy and finance theories, including the efficient market hypothesis).

80. *But see In re* Owen-Johnson, 118 B.R. 780, 782-83 (Bankr. S.D. Cal. 1990) (refusing to allow the debtor to use § 363(f)(4) as an "expeditious title clearing device" in order to avoid having to respond to and resolve the dispute in a pending state-court specific performance action).

81. No *per se* prohibition exists which prevents the debtor from regaining indirect ownership and control through sale to a debtor- or insider-controlled entity. *See supra* note 73.

82. Strategically, filing the Chapter 11 case in a different district where venue is otherwise proper will maximize the disruptive effect of the bankruptcy filing on the class action and minimize the chances of smooth coordination between the district and bankruptcy courts; likewise, it will disrupt the ease with which the district court can withdraw the reference of the

court action is automatically stayed.[83]

Meanwhile, the company continues to operate using the proceeds of the financing, while seeking to sell substantially all of its assets—including the balance of the proceeds—to a "white knight" conglomerate, which will continue the company's operations in a separate subsidiary, transferring the twenty million dollars into its central cash concentration account where it will be used to fund activities of the entire corporate group. The conglomerate will pay for the acquisition with its own stock, which is not presently publicly traded.[84] The debtor will distribute this stock to its creditors and stockholders under its Chapter 11 plan after the stock has been valued by the bankruptcy court.[85] If the sale of the assets for stock is approved under § 363(f)(4),[86] the most that recent investors can ever hope to receive—whether they take their

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Chapter 11 case to the bankruptcy court. *See* 28 U.S.C. § 1408 (2000) (venue of cases under title 11); § 1452 (removal of claims related to bankruptcy cases). If the securities fraud suit and the Chapter 11 case are both filed in the same district, the district court can simply withdraw the reference of the bankruptcy case to the bankruptcy court and hear both the securities fraud action and the Chapter 11 proceeding, perhaps consolidating them. Of course, interdistrict transfer is possible, *see* § 1412 (allowing for change of venue "in the interest of justice or for the convenience of the parties"), but it creates another level of complexity and delay for the plaintiffs as the debtor exercises its "second mover" advantage gained through the Chapter 11 filing.

83. 11 U.S.C. § 362(a)(1) (2000).

84. The transaction can be structured, with little difficulty, as a reverse triangular merger. If so, the conglomerate becomes a publicly traded company without having to comply with the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000), or the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (2000), and their related regulations, *see* 17 C.F.R. pts. 230, 240 (2003). *See generally* George W. Kuney, *Going Public Via Chapter 11: 11 U.S.C. Sections 1125(e) and 1145*, 23 CAL. BANKR. J. 3 (1996) (describing the use of taking a company public through a Chapter 11 reorganization plan).

85. The problem of stock valuation is very thorny and beyond the scope of this Article. Even if the stock is already publicly traded, market volatility and the likely effect of bulk sales by entities receiving stock under the plan make accurate valuation difficult, if not impossible. *See* Lynn M. LoPucki, *Comment: Stakeholder Interests and Bankruptcy*, 43 U. TORONTO L.J. 711, 712 (1993) (stating that determination of reorganization value by the court for purposes of valuing securities is a "guess compounded by an estimate"); David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 AM. U. L. REV. 63, 64 (1991) (positing that all bankruptcy court valuations are subjective, hypothetical, and inherently inaccurate); *see, e.g.*, Citibank, N.A. v. Baer, 651 F.2d 1341, 1347 (10th Cir. 1980) (noting the absurdity of the court's own valuation of over $90 million of as yet undiscovered oil in the Canadian Arctic down to the nearest $50); *see also* George W. Kuney, *Financial Reporting by Chapter 11 Debtors: A Limited Critique of SOP 90-7*, 5 J. BANKR. L. & PRAC. 311, 315-16 (1996) (finding accounting guideline unworkable because "reorganization value" is generally never determined by the court as such and is imprecise in any event). There is no substitute for the market in this respect.

86. Based upon the bona fide dispute that is the securities fraud action.

distribution on account of their fraud claims or their equity interests[87]—is the stock of the conglomerate. This outcome certainly is not the same as receiving their money back or recovering their prior equity interest in the stand-alone company, and is far from a minor modification of their contract, securities law, and tort rights involved in the class action.

Boiled down, this means that a soon-to-be debtor may be able to obtain property of another by conversion or fraud and then reorganize, using the value of the wrongfully obtained property and paying the prior owner only if that owner later successfully proves her case. In any event, the prior equity participants will not recover their property, even if they prevail.[88] The most they can expect is payment of its value, or an approximation of that value as pronounced by a bankruptcy judge, assuming the debtor has sufficient assets to make such a payment once the adjudication of rights is complete.

The main limitations on this scenario are imposed by the requirements of a bona fide dispute, good faith,[89] and a jurisdictional finding that the debtor or estate has an interest in the property in question.[90] These are slight limitations indeed.

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87. For purposes of this hypothetical, assume that equity holders will receive a distribution or be "in the money" so as to avoid the need for a discussion of 11 U.S.C. § 570(b) and subordination of securities-based claims to those of unsecured creditors.

88. This may be an overstatement. Under applicable nonbankruptcy law, courts recognize a distinction between whether or not the debtor acquires title to the property. If title is obtained, even if subject to rescission, the property will constitute property of the estate and a sale can proceed under § 363(f)(4) and the scenario discussed in the text. In contrast, if good title is not obtained, such as when the debtor obtains the property by outright theft, the property will not constitute property of the estate and § 363 cannot be used to effect its sale. *See* Kitchen v. Boyd (*In re* Newpower), 233 F.3d 922, 931 (6th Cir. 2000) (finding that money misappropriated by the debtor pre-petition was not property of the estate, but that proceeds of that money were property of the estate).

89. Good faith under § 363 is marked by the absence of "fraud, collusion between the purchaser and other bidders . . . , or an attempt to take grossly unfair advantage of other bidders." *In re* Rock Indus. Mach. Corp., 572 F.2d 1195, 1198 (7th Cir. 1978) (noting further that good faith is founded solely upon one's integrity of conduct during the sale process), *quoted in* Bleaufontaine, Inc. v. Roland Int'l (*In re* Bleaufontaine, Inc.), 634 F.2d 1383, 1388 n.7 (5th Cir. Unit B Jan. 1981), *In re* Apex Oil Co., 92 B.R. 847, 869 (Bankr. E.D. Mo. 1988).

90. ITNX v. Alpha Bus. Group, Inc. (*In re* Hurt), 9 Fed. Appx. 780, 781-82 (9th Cir. 2001); *see* Cont'l Nat'l Bank of Miami v. Sanchez (*In re* Toledo), 170 F.3d 1340, 1343 n.3 (11th Cir. 1999) ("It is questionable whether § 363(f) gives a bankruptcy court power to order or approve a sale of property that belongs only to an entity in which the estate holds an interest, and not to the estate itself."); Missouri v. United States Bankr. Court, 647 F.2d 768, 778 (8th Cir. 1981) (questioning the ability of the bankruptcy court to authorize the sale of property without a showing that the estate has a substantial ownership right to such property).

3. Section 363(f)(5)—The Standard That Could Have Swallowed the Others

The final alternative condition for a sale free and clear under § 363(f) is potentially the broadest of all: § 363(f)(5). It provides for sale free and clear of interests if the interest holder "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[91] The requirement is phrased in the passive voice and does not identify who or what is instituting the hypothetical proceeding that compels the interest holder to accept a money judgment. This suggests that there are no limits on the identity of the hypothetical actor or the type of legal or equitable proceeding. Plainly read, the statute indicates that if an entity can be forced to accept money for the property interest at law or in equity, its interest can be stripped off the asset in a § 363 sale.[92]

C. Sales Free and Clear of Claims?[93]

In a dramatic expansion of § 363(f)'s language into an interpretation that parallels the language of § 1141(c), some courts have concluded that unsecured[94] claims are a type of "interest" in property from which the property may be sold free and clear.[95] Although fundamentally flawed (since § 363(f)

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91. 11 U.S.C. § 363(f)(5) (2000). This Article refers to the legal or equitable proceeding as the "hypothetical proceeding."

92. *See* Basil H. Mattingly, *Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 431, 451-52 (1996) (championing this interpretation and the use of eminent domain as the source of a § 363(f)(5) power of sale free and clear of all interests). Eminent domain, or, more precisely, a proceeding to recover for an uncompensated taking by the state under its eminent domain power, is a legal or equitable proceeding, depending upon the forum and the regime under which it is brought. *See Misinterpretations I*, *supra* note *, at 254 n.74.

93. The text and footnotes of this subpart are largely derived from Kuney, *Misinterpretations I*, *supra* note *, at 257-69.

94. Because most tort claims are unsecured claims, they are the claims discussed here. For a discussion of sales free and clear of secured claims, see Kuney, *Misinterpretations I*, *supra* note *, at 257 nn.84-88 and accompanying text.

95. *See, e.g.*, *In re* Trans World Airlines, Inc., 322 F.3d 283, 293 (3d Cir. 2003) (holding that the sale of airline assets was free and clear of employment discrimination and travel voucher claims arising out of or connected to those assets); United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (*In re* Leckie Smokeless Coal Co.), 99 F.3d 573, 582 (4th Cir. 1996) (deferring to the apparent intent of Congress that the statute be read broadly after stating, "Yet while the plain meaning of the phrase 'interest in such property' suggests that not all general rights to payment are encompassed by the statute, Congress did not expressly indicate that, by employing such language, it intended to limit the scope of section 363(f) to *in rem* interests . . . ."); P.K.R. Convalescent Ctrs., Inc. v. Va. Dep't of Med. Assistance Servs. (*In re* P.K.R. Convalescent Ctrs., Inc.), 189 B.R. 90, 94 & n.3 (Bankr. E.D. Va. 1995) ("Under a § 363(f) sale, the purchaser acquires the property free and clear of all interests. Thus, the sale

does not include the term "claim" while § 1141(c) does), this interpretation is pervasive and is firmly defended.[96] This interpretation also has powerful consequences, which primarily include the use of a nonplan sale using § 363(f) to purportedly cut off successor liability that, under applicable nonbankruptcy law, could lie against the purchaser after a sale of substantially all of the assets of a business.[97]

The general rule is that a purchaser of assets for fair consideration does not

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extinguishes [a general unsecured creditor's] interest in the property because [the general unsecured creditor's] interest attaches to the proceeds of the sale.... [The creditor] possesses a contingent, unsecured, nonpriority claim."). Putting aside the thorny problem of future claims (i.e., those that have not yet arisen, such as a future wrongful death action arising out of the future use of a product manufactured defectively by a debtor pre-petition), the courts consistently hold that a preplan sale can be free and clear of existing claims held by creditors that receive notice. *See, e.g.*, Walker v. Lee (*In re* Rounds), 229 B.R. 758, 763 (Bankr. W.D. Ark. 1999) ("[E]ven notwithstanding the Code's concern for finality in bankruptcy sales, it 'will not... protect a [buyer]... where no notice [was] given to the lienholder[;] [s]uch a purchaser will be held to have purchased subject to the lien.'" (quoting W. Auto Supply Co. v. Savage Arms, Inc., 43 F.3d 714, 721 (1st Cir. 1994) (first and second alteration added)); *In re* Burd, 202 B.R. 590, 593 (Bankr. N.D. Ohio 1996) (noting that either the trustee or the debtor-in-possession "'may sell properties of the estate free and clear of liens by merely complying with the notice requirements of Bankruptcy Rule 2002(a)(2), (c)(1) and can effectively conclude the sale free and clear of any liens and encumbrances of all parties who were properly notified and given an opportunity to object...'" (quoting NORTON BANKRUPTCY RULES PAMPHLET 361 (1995-96) (editor's comment to FED. R. BANKR. P. 6004(c)))).

96. As one example, consider the following remarks made by two commentators, one of whom is a federal bankruptcy judge:

> State and federal decisions holding a bankruptcy purchaser liable as a successor of the debtor are directly at odds with Congressional intent to allow a debtor to sell its assets free and clear of all claims and interests therein. This conflict poses a constitutional dilemma that must be resolved in favor of the specific provisions of the Bankruptcy Code. Absent evidence of collusion or strong public policy concerns enunciated by Congress, a bankruptcy purchaser should not be held liable for a debtor's obligations. Any further extension of successor liability in the bankruptcy context is a policy decision best implemented by Congress pursuant to its exclusive jurisdiction over the subject of bankruptcy.

William T. Bodoh & Michelle M. Morgan, *Inequality Among Creditors: The Unconstitutional Use of Successor Liability to Create a New Class of Priority Claimants*, 4 AM. BANKR. INST. L. REV. 325, 364 (1996). Judge Bodoh and Ms. Morgan failed to note that § 363(f)'s "specific provisions" nowhere refer to "claims." Their point, based upon notions of broad federal preemption, is well taken—but only with regard to free-and-clear sales accomplished using § 1141(c) and a confirmed plan to vest property in a purchase free and clear of prior claims. Nevertheless, the Court of Appeals for the Third Circuit has recently endorsed the nonplan sale free and clear of claims, including successor-liability claims. *See Trans World Airlines*, 322 F.3d at 288-90; *see also supra* notes 39-50 and accompanying text.

97. *See supra* Part I (discussing the definition of "claim" and what claims can be discharged or stripped of assets or a business through a § 363(f) sale or § 1141(c) post-confirmation vesting).

become liable for the seller's liabilities, even when the purchaser purchases substantially all of the assets of the seller, unless the doctrine of successor liability comes into play.[98] Absent fraudulent transfers, acquisition of all or substantially all of a company's assets is a necessary but, by itself, insufficient element for a finding of successor liability.[99] Where exceptions to the general rule of no-successor-liability-for-asset-purchasers are accepted, they typically require an additional element over mere acquisition of substantially all the assets of an entity to impose successor liability.[100] The findings[101] that can constitute the additional element needed to impose successor liability on an asset purchaser include:

(1) The presence of an express or implied assumption of liabilities in the purchase agreement;

(2) The transaction amounts to a consolidation or a "de facto merger";

(3) The purchasing corporation is "merely a continuation" of the seller;

(4) The transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts; or

(5) In some jurisdictions that apply the "product line" exception,[102] the

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98. *See* Schwartz v. McGraw-Edison Co., 92 Cal. Rptr. 776, 783-84 (Ct. App. 1971), *disapproved by* Ray v. Alad Corp., 560 P.2d 3, 5, 11 (Cal. 1977); Dana Corp. v. LTV Corp., 668 A.2d 752, 756 (Del. Ch. 1995) ("[A successor] will be exposed to liability only if a court follows some exception to the traditional rule that a transfer of assets does not pass liabilities unless the transferee agrees to assume them."), *aff'd*, 670 A.2d 1337 (Del. 1995) (unpublished table decision); Husak v. Berkel, Inc., 341 A.2d 174, 176 (Pa. Super. Ct. 1975) ("Ordinarily when one company sells or transfers all its assets to another company, the latter is not liable for the debts and liabilities of the transferor simply by virtue of its succession to the transferor's property."); Schumacher v. Richards Shear Co., 451 N.E.2d 195, 198 (N.Y. 1983) ("It is the general rule that a corporation which acquires the assets of another is not liable for the torts of its predecessor.").

99. *See* Acheson v. Falstaff Brewing Corp., 523 F.2d 1327, 1330 (9th Cir. 1975) (finding no successor liability because the purchaser had not acquired accounts, customer lists, trade names, or goodwill); *see also McGraw-Edison*, 92 Cal. Rptr. at 784 (finding that a purchaser who did not acquire substantially all of a business and who paid valuable and adequate consideration was not liable in tort for defective products manufactured by a seller that continued to exist as a separate corporate entity with substantial assets to meet its debts).

100. *See* RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 12 (1998) (collecting and discussing authorities). Essentially, successor liability allows the subsequent owner of a going concern to be held liable for the torts of a prior owner. The starting point for all forms of successor liability is the sale of substantially all the assets of a business, and the five additional, alternative elements, *see infra* text accompanying note 101, which largely point to the continued operation of those assets as the business that caused the liability in the first place.

101. For a summary of authorities that have made these findings, see Kuney, *Misinterpretations I*, *supra* note *, at 259 n.92.

102. In 1977, the Supreme Court of California first introduced the "product line" exception when it decided *Ray v. Alad Corp*, 560 P.2d 3 (Cal. 1977). Since that time, courts in Mississippi, New Jersey, New Mexico, New York, Pennsylvania, and Washington have adopted the product line exception, while courts in Colorado, Connecticut, the District of Columbia,

asset purchaser continued production of the transferor's product line with the assets purchased.

Interpreting § 363(f) to allow preplan sales free and clear of claims also expands the number of cases in which such a sale can take place. Because Chapter 7 trustees operate in a nonplan environment,[103] if the power to sell free and clear of claims were confined to vesting of title under a confirmed plan and § 1141(c), these trustees would not be able to conduct sales free and clear of claims.[104] Unlike most benefits created by the Code, this power to shield purchasers from successor liability only indirectly benefits debtors and their creditors—arguably by increasing the price that purchasers are willing to pay for the assets involved—and instead directly and substantially benefits the third-party purchaser, who may otherwise be a complete stranger to the case.[105] The one exception to this outcome would be in precisely the area where it is fairly clear that the free and clear process cannot shield the purchaser: future claims.[106]

Making the analytical leap to the conclusion that claims are a subset of interests[107] has conveniently allowed preplan sales free and clear of interests

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Florida, Georgia, Illinois, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Texas, Vermont, Virginia, and Wisconsin have rejected it. For a sampling of decisions from these jurisdictions, see Kuney, *Misinterpretations I*, *supra* note *, at 259 n.92.

103. *See* 11 U.S.C. §§ 701-784 (2000) (Chapter 7 is devoid of plan provisions).

104. This, in turn, might depress the prices that trustees would realize from sales, arguably impacting negatively on unsecured creditors. This negative impact, however, is the product of correctly interpreting the statute as enacted and erasing a judicial gloss that has, perhaps, produced a windfall for unsecured creditors.

105. Based upon pure economic theory, purchasers should be willing to pay more for the property free from liability than they would otherwise, and the higher purchase price would benefit creditors. Although, assuming something approaching a perfect market, this outcome is true in theory, it is not—in the author's experience—the case in practice. The ability to sell free and clear has the primary effect of enticing a purchaser to consider a transaction that might otherwise be ignored because it has too much "hair" on it—much of which is the threat of unknown or contingent claims and successor liability. Once the purchaser entertains the transaction, little value is, at least expressly, attributed to the free and clear nature of the sale. Further, the bankruptcy sale process is not a perfect market in any sense; there is no perfect information, no multitude of willing buyers and sellers, and no absence of a compulsion to buy or sell. The process is often controlled by insiders and secured creditors who, in reality, have other things on their minds than increasing returns to unsecured creditors. In sum, these characteristics of a typical bankruptcy sale, when combined with the use of blanket liens in secured financing, mean that whatever excess value the purchaser does attribute to the free-and-clear nature of the sale will generally not trickle down below the ranks of the secured creditors and administrative claimants.

106. *See infra* notes 116-17 and accompanying text (discussing the early view that future claims could be cut off, and the more recent and better reasoned view that they cannot be cut off consistent with due process under the current statute).

107. The leap appears to be driven by the observation that successor-liability rights follow

and claims under § 363(f). Therefore, through conflation of these terms, purchasers are protected from successor liability without having to navigate through the plan proposal and confirmation process that otherwise would allow purchasers to use § 1141(c) to accomplish the same end.

Despite § 363(f)'s explicit reference to sales free and clear solely of "interests,"[108] these sales are commonly referred to as sales free and clear of "claims and interests."[109] Moreover, bankruptcy courts often enter extensive findings of fact and conclusions of law supporting § 363(f) sale orders that contain detailed provisions insulating the purchaser from liability.[110] Given

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the property; however, this observation is imprecise and, consequently, fails to convert such claims into *in rem* claims. A review of the development of successor liability under judge-made law reveals the more accurate observation that such claims follow *the business*, not the property. *See* Fairchild Aircraft Inc v. Campbell (*In re* Fairchild Aircraft Corp.), 184 B.R. 910, 920 (Bankr. W.D. Tex. 1995) ("[W]hile successor liability may give a party an alternative entity from whom to recover, the doctrine does not convert the claim to an *in rem* action running against the property being sold. Nor does the claim [exist independently from] the underlying liability of the entity that sold the assets." (footnote omitted)), *vacated by* 220 B.R. 909 (Bankr. W.D. Tex. 1998).

108. When the statute addresses claims *and* interests, it does so explicitly. *See, e.g.*, 11 U.S.C. § 1141(c) (stating that property dealt with under a confirmed plan of reorganization passes free and clear of "all claims and interests"); § 1327(c) (stating that confirmation of a plan vests property of the estate in the debtor free and clear of "any claim or interest"). Interpreting "interest" to include "claims" makes the use of the phrase "claims and interests" two-thirds surplus, in terms of word count, both as used in the statute and as used in practice. The statute was carefully worded, and the use of specific terms should be honored. *Cf.* United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 n.5 (1989) ("When Congress wanted to restrict the application of a particular provision of the Code to [voluntary] liens, it used the term 'security interest.'").

109. For examples of representative cases using such language to describe the title and context of sales orders, see Kuney, *Misinterpretations I*, *supra* note *, at 265 n.115.

110. In practice these findings of fact and conclusions of law are drafted by the debtor's counsel and the purchaser's counsel, who insert detailed provisions to insulate their clients and themselves from liability. The following finding of fact and conclusion of law from a § 363 sale order is typical:

> Pursuant to Bankruptcy Code sections 105(a) and 363(f), upon the closing under the Agreement, [the purchaser] shall acquire all title, right and interest in the [purchased assets], subject only to the Assumed Liabilities (as defined in the Agreement). The [purchased assets] shall be free and clear of (a) all Encumbrances and Other Interests, and (b) all debts arising in any way in connection with any acts, or failures to act, of the Debtors or the Debtors' predecessors or affiliates, claims (as that term is defined in the Bankruptcy Code), obligations, demands, guaranties, options, rights, contractual commitments, restrictions, interests and matters of any kind and nature, whether arising prior to or subsequent to the commencement of these cases, and whether imposed by agreement, understanding, law, equity or otherwise (collectively, the "Claims"), with all such Encumbrances, Other Interests and Claims to attach to the net proceeds of the sale of the [purchased assets] in the order of their priority, with the same validity, force and effect which they now have as against the [purchased assets], subject to any claims and

the breadth of these findings and conclusions, those championing them would prefer for the free and clear power to emanate from § 363—rather than emanating merely from § 105(a), the Bankruptcy Code's "all writs" provision[111]—to protect the order and findings from vulnerability on appeal.[112] This practice is national in scope.[113]

Thus, although there is no indication that § 363(f) was intended to be used to bar successor-liability claims,[114] and although § 1141(c) provides a plan

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defenses the Debtors may possess with respect thereto.

In re FPA Med. Mgmt., Inc., Nos. 98-1596 (PJW) to 98-1685 (PJW), ¶ 5 (Bankr. D. Del. Sept. 23, 1998) (order authorizing the sale of purchased assets free and clear of liens, claims, encumbrances, and interests) (on file with the Tennessee Law Review and author).

111. Section 105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a).

112. Section 105 is a fall-back equitable power provision used to plug what would otherwise be gaps in the statutory scheme; however, § 105's grant of power is limited if other portions of title 11 address a subject scheme. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206-07 (1988) (noting that bankruptcy courts' equitable powers are limited and concluding that such powers should not be exercised to prevent conduct that is specifically authorized by the Code); *see also* 11 U.S.C. § 524(e) (prohibiting the discharge of debts of nondebtor entities, which would presumably include purchasers). *But see Fairchild Aircraft*, 184 B.R. at 933 n.28 (noting that a § 105 injunction can be used to block claims of successor liability but cannot bind future claimants who do not yet hold "claims" and are not part of the plan or sale process). *See generally* Jeffrey Davis, *Cramming Down Future Claims in Bankruptcy: Fairness, Bankruptcy Policy, Due Process, and the Lessons of the Piper Reorganization*, 70 AM. BANKR. L.J. 329 (1996) (reviewing and analyzing successor liability, the future claim problem, and the evolution of case law in this regard).

113. See Kuney, *Misrepresentations I*, *supra* note *, at 265 n.115, for a discussion of the titles and terms of sale orders in four cases: one in Arizona, one in California, one in Delaware, and one in New York.

114. Legislative history accompanying the enactment of House Bill 8200 is devoid of references to successor liability. *See* H.R. REP. NO. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963. Although courts have expressed disbelief over a plain language reading of § 363(f) in terms of the scope of true property interests that can be stripped away and the hypothetical proceedings that can be used to satisfy § 363(f)(5), *see* Kuney, *Misinterpretations II*, *supra* note *, at 310 n.100, they have readily accepted a reading of the statute that includes the words "claims and," which nowhere appear in the statute. Instead, courts only balk, if at all, at the prospect of stripping off the claims of future, unidentifiable claimants on due process grounds, given the inability to give meaningful notice to those claimants. *See, e.g.*, *Fairchild Aircraft*, 184 B.R. at 934; *In re* Piper Aircraft Corp., 162 B.R. 619, 625 (Bankr. S.D. Fla. 1994), *aff'd sub nom.* Epstein v. Official Comm. of Undersecured Creditors of the Estate of Piper Aircraft, Inc. (*In re* Piper Aircraft Corp.), 168 B.R. 434 (S.D. Fla. 1994), *aff'd as modified*, 58 F.3d 1573 (11th Cir. 1995).

confirmation process to achieve this same end,[115] a majority of courts have interpreted § 363(f) as permitting the sale of property free and clear of claims that otherwise could be asserted against the buyer of the assets under the doctrine of successor liability.[116] Some courts have used § 363(f) to bar tort claims that arise postsale from the use of a product manufactured presale or pre-petition, although this use is questionable in light of more recent cases.[117]

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115. *See* 11 U.S.C. § 1141(c).

116. These courts have long embraced the concept that "claims" are a subset of "interests," apparently without much thought or analysis. *See, e.g.*, Paris Mfg. Corp. v. Ace Hardware Corp. (*In re* Paris Indus. Corp.), 132 B.R. 504, 510 n.14 (D. Me. 1991) (remarking in dicta that a sale free and clear of future claims would be consistent with policies of the Bankruptcy Code); Am. Living Sys. v. Bonapfel (*In re* All Am. of Ashburn, Inc.), 56 B.R. 186, 189-90 (Bankr. N.D. Ga. 1986) (collecting cases in support of its implicit conclusion that claims are a subset of interests, and holding that assets sold under § 363(f) were free and clear of successor-liability claims), *aff'd*, 805 F.2d 1515 (11th Cir. 1986); *In re* Johns-Manville Corp., 57 B.R. 680, 690 (Bankr. S.D.N.Y. 1986) (considering, impliedly as an interest, claims for indemnification and contribution), *aff'd*, 843 F.2d 636 (2d Cir. 1988); Forde v. Kee-Lox Mfg. Co., 437 F. Supp. 631, 634-35 (W.D.N.Y. 1977) (holding that a sale free and clear barred a civil rights suit based upon the defendant's presale conduct), *aff'd*, 584 F.2d 4 (2d Cir 1978). *But see* W. Auto Supply Co. v. Savage Arms, Inc. (*In re* Savage Indus., Inc.), 43 F.3d 714, 723 (1st Cir. 1994) (refusing to enjoin a suit commenced by the holder of a presale claim against the purchaser of the debtor's assets because the claimant was given insufficient notice of the sale and there was no showing that the successor-liability action posed a genuine threat to the legitimate operation of the Bankruptcy Code). The reaction of practitioners to *Savage Arms* has been predictable: increased attention to wide notice, including notice by publication, and inclusion of a self-serving finding in § 363(f) sale orders establishing the "necessity" of a bar to successor liability to consummate the sale. 1 WEIL, GOTSHAL & MANGES LLP, *supra* note 64, at 11-25 to -26. The one limit on sales free and clear of claims appears to be that claims which first arise postsale will not be barred by the free and clear provisions of the sale order. *See Piper Aircraft*, 58 F.3d at 1577 (establishing the "Piper Test," which states that, to be barred by a sale free-and-clear order, a claim must be based upon the debtor's pre-petition activities, and "events occurring before confirmation, or a preplan sale, must create a relationship, such as contact, exposure, impact, or privity between the claimant and the debtor's product"); *accord Fairchild Aircraft*, 184 B.R. at 933.

117. Cases supporting the proposition that a sale free and clear bars future claims include *Paris Industries Corp.*, 132 B.R. at 509 (barring a tort claim, based upon a defective sled manufactured and sold by the predecessor pre-petition, when asserted against the purchaser of assets at a 363(f) sale), and *All American of Ashburn*, 56 B.R. at 190. *But see* Chi. Truck Drivers Union (Indep.) Pension Fund v. Tasemkin, Inc., 59 F.3d 48, 50-51 (7th Cir. 1995) (discussing the troubling and problematic nature of a *per se* rule barring successor-liability claims when the injury has not yet occurred and the claimant is not known, and thus has no opportunity to receive notice and be heard to object); *Savage Arms*, 43 F.3d at 723; Zerand-Bernal Group, Inc. v. Cox, 23 F.3d 159, 163 (7th Cir. 1994). More recent decisions seemingly foreclose this application of the statute and, on due process grounds, limit the claims that can be barred. *See, e.g.*, Fogel v. Zell, 221 F.3d 955, 960 (7th Cir. 2000) (holding that, as to future tort claims such as products liability claims, no "claim" arises until the actual harm occurs and rejecting the notion that a pedestrian has a contingent claim against every automobile that might

It was even used in *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*[118] to support a mass tort debtor's settlement with its insurer featuring the establishment of a settlement fund by the insurer and the entry of a channeling injunction, forcing tort plaintiffs to assert their claims, if at all, against that fund.[119]

D. The Effects of Including "Claims" Within "Interests" in § 363(f)[120]

The courts' inclusion of "claims" within "interests" under § 363(f)[121] and the erosion of the bias against preplan sales of substantial groups of assets[122] have led to the use of Chapter 11 both to achieve a prenegotiated sale of a business or group of assets and to protect the buyer from successor liability. These expansive views, when combined with other characteristics of Chapter 11 proceedings—the lack of any requirement that a debtor be insolvent,[123]

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hit him); *Fairchild Aircraft*, 184 B.R. at 927; *Piper Aircraft*, 162 B.R. at 628; *see also* Barbara J. Houser et al., *Mass Torts and Other Future Claims, in* 1 ALI-ABA COMM. ON CONTINUING PROF'L EDUC., ALI-ABA COURSES OF STUDY, BUSINESS REORGANIZATIONS 97-107 (1997) (collecting authorities and analyzing different approaches to the problem).

118. 837 F.2d 89 (2d Cir. 1988).

119. *Id.* at 93; *see* Kane v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 843 F.2d 636, 638-39 (2d Cir. 1988) (upholding the confirmation of a plan with similar provisions); *In re* A.H. Robins Co., 88 B.R. 742, 751 (E.D. Va. 1988) (confirming a plan with a channeling injunction), *aff'd sub nom.* Menard-Sanford v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694 (4th Cir. 1989). These cases and others like them dealing with channeling injunctions and nondebtor releases are beyond the scope of this Article, except to note their existence and their connection to the power to sell assets (such as insurance rights and proceeds) free and clear of claims and interests under § 363(f).

120. The text and footnotes of this subpart are largely derived from Kuney, *Misinterpretations I*, *supra* note *, at 272-86.

121. *See supra* notes 63-64, 94-119 and accompanying text.

122. *See supra* notes 35-50.

123. *In re* Johns-Manville Corp., 36 B.R. 727, 730 (Bankr. S.D.N.Y. 1984); *cf.* Baker v. Latham Sparrowbush Assocs. (*In re* Cohoes Indus. Terminal, Inc.), 931 F.2d 222, 228 (2d Cir. 1991) (noting that although the debtor need not be insolvent to file a bankruptcy petition, it must be in such "financial stress" that, were it not to file, it "could anticipate the need to file in the future"). *But see* Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN L. REV. 487, 545-56 (1996) (positing that balance sheet or cash flow insolvency of the debtor is an inherent limitation on the Bankruptcy Clause); Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not Be Article III Judges*, 72 AM. BANKR. L.J. 567, 629-36 (1998) (arguing against the proposed life appointment of bankruptcy judges under Article III of the U.S. Constitution because, among other reasons, retaining their current status would reinforce the fact that their activities are limited to the permissible scope of bankruptcy law: the adjustment of the *insolvent* debtor-creditor relationship). According to Professor Plank's research, this principle requires that a debtor may not be in bankruptcy unless the debtor is insolvent in either a balance sheet sense or a cash flow sense. *Id.* at 630. He also notes that there was an explicit insolvency requirement under federal bankruptcy law for liquidations until

vague "[you] know it when [you] see it" standards[124] regarding good faith in commencing a bankruptcy case,[125] and the ability of the dominant parties to create a business justification for a quick sale[126]—are turning the bankruptcy courts into the auction houses of choice for businesses with either financial trouble or the potential of liabilities that would otherwise follow their assets.[127]

1939 and for reorganizations until 1979. *Id.* at 631 & n.346. The *Johns-Manville* rule—insolvency is not required—however, remains hornbook black letter law. In attempting to harmonize these two views, it should be noted that in today's highly leveraged world of business, debtors can easily manipulate their balance sheets, operations, and cash flow to produce the insolvency or looming insolvency that Professor Plank's view requires. *See generally* KEVIN J. DELANEY, STRATEGIC BANKRUPTCY 60-81 (reviewing the stream of events leading to Johns-Manville's recognition, on the eve of its bankruptcy filing, of two billion dollars in contingent asbestos litigation claims that, without invoking the automatic stay by filing a bankruptcy petition, would have allowed its lenders to accelerate loans and other debts, thereby rendering its balance sheet insolvent as well as rendering the company unable to meet its debts as they came due).

124. *Cf.* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (discussing the difficulty of defining obscenity with any concreteness).

125. "The test [for good faith] is whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis." Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994) (citing Idaho Dep't of Lands v. Arnold (*In re* Arnold), 806 F.2d 937, 939 (9th Cir. 1986)); Meadowbrook Investors' Group v. Thirtieth Place, Inc. (*In re* Thirtieth Place, Inc.), 30 B.R. 503, 505 (B.A.P. 9th Cir. 1983) (noting that good faith cannot be denied where it is evident that the debtor is "'attempt[ing] to effect a speedy efficient reorganization, upon a feasible basis'" (quoting *In re* Levinsky, 23 B.R. 210, 218 (Bankr. E.D.N.Y. 1982))). "Good faith is lacking only when the debtor's actions are a clear abuse of the bankruptcy process." *Arnold*, 806 F.2d at 939 ("The existence of good faith depends on an amalgam of factors and not upon a specific fact."). The ovular case of *Little Creek Development Co. v. Commonwealth Mortgage Corp.* (*In re Little Creek Development*), 779 F.2d 1068, 1073 (5th Cir. 1986), identified ten common conditions indicating bad faith, generally aimed at single-asset real estate cases, but which are unfortunately exhibited by most real-property-owning entities at one time or another, whether they are financially-strapped or commercial.

126. Compare *Wolf v. Weinstein*, in which the Supreme Court stated:

> [O]ne who exercises control over a reorganization [plan] holds a post which might tempt him to affect or influence corporate policies—even the shaping of the very plan of reorganization—for the benefit of his own security holdings but to the detriment of the Debtor's interests and those of its creditors and other interested groups.

372 U.S. 633, 642 (1963).

127. *See* Brian L. Davidoff, *Reorganizing the Internet Company*, BCD NEWS & COMMENT, Feb. 7, 2001 (discussing different methods for valuing Internet companies in the bankruptcy process); Luis Salazar, *The Difficulties Practitioners Can Face When Dealing with Dot-Com Bankruptcies*, 18 BANKR. STRATEGIST, Nov. 2000, at 1 (predicting the deluge of dot-com bankruptcies); John Shinal, *Dead Dot-Coms Can Still Cause Havoc*, BUS. WK., Mar. 12, 2001, at 50 (explaining that dot-com bankruptcy filings have led to the auctioning of computer equipment at "dirt-cheap prices"); *Dot-Coms Filing Bankruptcy Unconventionally* (Oct. 15, 2001), *at* http://www.usatoday.com/life/cyber/invest/2001/10/15/dot-com-bankruptcies.htm.

In fact, some counsel generally advise clients who purchase such businesses[128] that the preferred method of acquisition is through a quick Chapter 7 or 11 case featuring a prenegotiated asset purchase agreement and a preplan § 363(f) sale free and clear. Indeed, it may already constitute malpractice not to at least advise clients of the potential benefits of this process in many circumstances.

It is difficult to assess with any degree of accuracy the impact of preplan sale procedures on distributions to unsecured creditors, including tort claimants. On balance, however, the impact is probably negative. The speed of the nonplan sale process may help minimize administrative claims in the case, thus ostensibly benefitting these creditors who, possessing general unsecured claims, are junior in priority to both secured and priority creditors, including administrative claimants. However, in reality, this apparent advantage will generally be of no or very little benefit to tort claimants and other unsecured creditors. First, distributions to these lower priority creditors are often extremely low in any event.[129] These low distributions may be attributed to the fact that: (i) secured creditors often use blanket liens to capture the value of all assets at the inception of pre-petition financing or the extension of debtor-in-possession financing, and (ii) business entities may select from among many different judgment-proofing strategies that are designed to channel profits and value to the equity holders and insiders.[130] Theoretically, any process that decreases higher priority claims and expenses would benefit these classes, but empirical evidence has yet to be gathered showing any significant benefit.

Second, the increase in preplan sales appears to negatively impact the

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128. The protections afforded by conducting the transaction within a bankruptcy case are not limited to purchasers. The officers, directors, and insiders of the debtor-seller can often benefit from having the sale approved by a bankruptcy court, which can, and often does, enter findings of fact and conclusions of law that accompany the sale order to the effect that, among other things, the sale is for fair value and reasonably equivalent consideration; the bankruptcy case and the sale are supported by the informed business judgment of the officers and directors of the debtor, formed after reasonable inquiry under the circumstances; and the sale is in the best interests of stockholders, creditors, and all other stakeholders. Such findings are, of course, drafted by the prevailing parties to serve their own interests in defending against later claims and lawsuits. They are often justified, if at all, as a condition of closing imposed by the purchaser, who seeks to insulate itself from claims of fraudulent transfer or similar claims that could result in rescission, avoidance or unwinding of the sale, or litigation—all of which could distract the insiders of the debtor from their postsale duties to the purchaser, who will hire them immediately after closing. *See generally In re* Automationsolutions Int'l, LLC, 274 B.R. 527 (Bankr. N.D. Cal. 2002) (discussing and disparaging an over broad "comfort order," drafted by the purchaser, approving the sale).

129. *See supra* note 27 and accompanying text; *infra* note 130 and accompanying text.

130. *See* Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 152-53 (1998) (describing judgment-proofing techniques, including leases, secured lending instruments, sale agreements, franchise agreements, licenses, and the formation of operating subsidiaries).

ability of low priority creditors to meaningfully participate in the proceedings and look after their interests, to the extent they are so inclined.[131] When a debtor's business is sold preplan, these creditors lose the specific protections of § 1129, including the best-interests-of-creditors test,[132] the requirement that there be at least one consenting impaired class,[133] and the absolute priority rule.[134] Although creditors' committees and their counsel ensure some protections, the speed at which preplan sales proceed certainly makes it less likely that individual creditors will be able to meaningfully participate. On balance, it is hard to see how speeding up the reorganization case increases the negotiating leverage of these creditors or provides anything but a decrease in the flow and quality of information they receive and the ability to protect their particular interests.

Finally, depriving unsecured creditors of their successor-liability claims against a purchaser deals a devastating blow to their chances of recovery.[135] Absent a strong showing that the values received by the estate will be enhanced sufficiently to meaningfully increase dividends to general unsecured creditors, there is nothing to outweigh these negatives.

In some sense, the bankruptcy system is being used to solve the problem

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131. *See* Lynn M. LoPucki, *The Debtor in Full Control-Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 247, 248 (1983) ("[C]reditors '[take] little interest' in bankruptcy proceedings only because bankruptcy legislation ha[s] failed to provide the means for them to exercise meaningful control or to make their participation profitable." (quoting H.R. Rep. No. 95-595, at 92 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6053 (alteration in original))).

132. 11 U.S.C. § 1129(a)(7)(A) (2000) (stating that a confirmable plan must provide that every creditor either accepts the plan or will receive at least as much as it would in a hypothetical liquidation).

133. 11 U.S.C. § 1129(a)(10). Because this element is not present in the preplan sale process, theoretically the debtor could proceed to sale without support from any class of creditors. Although this possibility is unlikely in practice, it is a dramatic difference from the plan process.

134. 11 U.S.C. § 1129(b)(2).

135. *See In re* Lady H Coal Co., 193 B.R. 233, 249 (Bankr. S.D. W. Va. 1996) (declining the debtors' request that the court reject the debtors' collective bargaining agreement, but approving the proposed sale of substantially all of the debtors' assets free and clear of any interest imposed by that agreement); *accord* N.Y. Typographical Union No. 6 v. Maxwell Newspapers, Inc. (*In re* Maxwell Newspapers, Inc.), 981 F.2d 85, 89 (2d Cir. 1992); After Six, Inc. v. Phila. Joint Bd. (*In re* After Six, Inc.), No. 93-111505, 1993 WL 160385, at *2 (Bankr. E.D. Pa. May 13, 1993). The preplan sale free-and-clear process effectively guts whatever protection would otherwise be afforded by § 1114 and § 1129(a)(13). The only argument that can be made in support of this result is that the same result would follow if the liquidation of the debtor's assets were to take place in a Chapter 7 case. *See In re* Ionosphere Clubs, Inc., 134 B.R. 515, 521 (Bankr. S.D.N.Y. 1991) (recognizing that § 1114 does not apply to Chapter 7 cases, but concluding that, based on the statute's plain language, it must apply to liquidating Chapter 11 cases, even though the legislative history suggests that Congress believed that Chapter 11 did not include liquidating cases when it enacted the statute).

caused by business purchasers' inability to take much comfort in the representations, warranties, and indemnities of the seller of a business, whether failing or not, or of its principals. A free-and-clear order that is final and nonappealable, backed by the Bankruptcy and Supremacy Clauses of the United States Constitution, and entitled to full faith and credit in federal and state courts across the country is an effective tool indeed. By foreclosing the claims as a matter of law, the parties need not design an effective transactional mechanism to allocate risk between them—section 363(f), as interpreted, eliminates the risk. The losers under this scheme include tort victims, successor-liability claimants, smaller, low priority creditors, and slow-moving entities and agencies.[136]

III. THE EFFECT OF INCLUDING ENTITY COVERAGE IN THIRD-PARTY LIABILITY POLICIES

Many debtors facing massive tort liability hold insurance policies under which their directors and officers are beneficiaries ("D&O Policies").[137] Further, directors and officers may face exposure to liability for the debtor's torts either directly, as codefendants that knowingly or negligently participate in the tortious conduct, or indirectly, under theories such as breach of fiduciary duty to creditors and shareholders or the alter ego doctrine. In such instances, the existence of the D&O Policy may appear to the tort claimant as a blessing and assurance of a payoff if a judgment is entered and sustained on appeal.

Enter bankruptcy, again, with a wrinkle. The proceeds of the D&O Policy may be held to be property of the debtor's estate, in which case claims for those policy proceeds may be stayed or even permanently prohibited.

A. D&O Policies

Although § 362(a) of the Bankruptcy Code stays any sort of litigation that potential plaintiffs could bring against a *debtor* in bankruptcy, the automatic

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136. This may be yet another example of the trend towards the elimination of any real liability of incorporeal entities beyond their insurance policies. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 14-38 (1996) (arguing that American businesses are rendering themselves judgment proof because of the ease with which a modern debtor can grant secured credit, the growth of asset securitization, the availability of foreign havens for hiding assets, and the traditional ways of avoiding legal liability, such as scattering assets among subsidiaries). *But see* James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's* The Death of Liability, 107 YALE L.J. 1363, 1368-95 (1998) (arguing that American businesses are not judgment proof and pointing to data showing that public companies grant much more modest levels of security than would be necessary to become judgment proof, that most companies have lien-free assets that greatly exceed their liabilities, and that most companies carry substantial amounts of liability insurance).

137. D&O Policies are insurance policies that generally insure a corporation's directors and officers against personal liability arising from their employment with the corporation.

stay does not generally prevent plaintiffs from suing third parties.[138] Thus, while the debtor-corporation may be immune from nonbankruptcy related litigation, its insiders,[139] as third-party nondebtors, can be held liable for tort damages in suits brought directly against them.[140] Even if such suits are unsuccessful, insiders will have to pay for attorneys' fees and court costs.

An uncontroversial method of limiting or covering the personal liability of insiders is for the debtor to purchase a D&O Policy naming the insiders as beneficiaries. This type of insurance coverage not only insures the insiders against possible claims for damages, but also against the litigation expenses associated with defending suits.[141] From a plaintiff's perspective, these D&O Policies are attractive sources of payment for a judgment because they appear to represent funds in the hands of a solvent third party rather than in the hands of a potentially insolvent debtor.

Additionally, D&O Policies often insure the debtor-corporation against any claim for indemnification brought by an insider ("Indemnity Coverage").[142] Generally, D&O Policies consist of a combination of three

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138. Section 362(a) stays any actions by a party against the debtor taken to acquire property of the bankruptcy estate. In relevant part, § 362(a) states:

> Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding *against the debtor* that was or could have been commenced before the commencement of the case under this title, or to recover a claim *against the debtor* that arose before the commencement of the case under this title;
>
> (2) the enforcement, *against the debtor or against property of the estate*, of a judgment obtained before the commencement of the case under this title.

11 U.S.C. § 362(a) (emphasis added). However, this stay only protects the *debtor* from the commencement or initiation of suits; the plain language of § 362 affords no protection for related nondebtors. *See* Aetna Cas. & Sur. Co. v. Namrod Dev. Corp., 140 B.R. 56, 59 (S.D.N.Y. 1992) (citing Teachers Ins. & Annuity Ass'n of Am. v. Butler, 803 F.2d 61, 65 (2d Cir. 1986); GAF Corp. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 26 B.R. 405, 414 (Bankr. S.D.N.Y.1983)).

139. "Insider" is defined in 11 U.S.C. § 101(31(B)-(C)) to include directors, officers, general partners, and others that control or are responsible for the acts of incorporeal entities such as corporations and partnerships. In other words, insiders are likely to be the codefendants of the debtor in tort suits.

140. For example, plaintiffs may recover from insiders directly under federal securities laws, imposing personal liability on the directors and officers of publicly traded corporations, or under state common-law fraud.

141. *See, e.g.*, Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (*In re* Adelphia Communications Corp.), 285 B.R. 580, 586-89 (Bankr. S.D.N.Y. 2002) (concerning an insurance policy that covered both losses and the costs of litigation incurred by its insider-beneficiaries, but had exceptions for intentional or criminal conduct).

142. Many state corporation laws and corporation charters require corporations to

distinct types of insurance coverage: (i) insurance against claims brought by plaintiffs directly against the debtor's directors and officers ("Liability Coverage");[143] (ii) insurance against claims for indemnification brought by directors and officers against the debtor-corporation ("Indemnity Coverage");[144] and (iii) insurance against securities laws claims brought by plaintiffs directly against the debtor-corporation ("Entity Coverage").[145] Although a corporation owns the D&O Policy, the main purpose of the policy is to insure insiders against personal liability arising from their employment with the corporation—even when the corporation is a named beneficiary under the policy.[146]

1. Pre-petition D&O Policies

In many cases, corporations purchase D&O Policies for their insiders outside bankruptcy—long before the company ever anticipates filing a Chapter 11 petition. As long as the corporation remains current with its premiums and other obligations, these policies become property of the estate.[147] However,

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indemnify their directors and officers. D&O Policies covering a corporation for indemnity claims ensure that the corporation will be able to satisfy these obligations.

143. *See, e.g.*, La. World Exposition, Inc. v. Fed. Ins. Co. (*In re* La. World Exposition, Inc.), 832 F.2d 1391, 1398-99 (5th Cir. 1987) (concerning a D&O Policy containing Liability and Indemnity Coverage, but considering the rights of the parties based solely on the Liability Coverage); *cf.* Houston v. Edgeworth (*In re* Edgeworth), 993 F.2d 51, 55-56 (5th Cir. 1993) (examining the rights of parties under a medical malpractice insurance policy in which the sole beneficiaries were injured patients).

144. *See, e.g.*, Executive Risk Indem., Inc. v. Boston Reg'l Med. Ctr., Inc., (*In re* Boston Reg'l Med. Ctr., Inc.), 285 B.R. 87, 88-89 (Bankr. D. Mass. 2002) (concerning a D&O Policy containing both Liability and Indemnity Coverage); Youngstown Osteopathic Hosp. Ass'n v. Ventresco (*In re* Youngstown Osteopathic Hosp. Ass'n), 271 B.R. 544, 546-47 (Bankr. N.D. Ohio 2002).

145. *See, e.g.*, *Adelphia Communications*, 285 B.R. at 586 (concerning a D&O Policy containing Liability, Indemnity, and Entity Coverage); *In re* Cybermedica, Inc. 280 B.R. 12, 14 (Bankr. D. Mass. 2002); Ochs v. Lipson (*In re* First Cent. Fin. Corp.), 238 B.R. 9, 14 (Bankr. E.D.N.Y. 1999); Circle K Corp. v. Marks (*In re* Circle K Corp.), 121 B.R. 257, 260-61 (Bankr. D. Ariz. 1990).

146. *See La. World Exposition*, 832 F.2d at 1398-99; *Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. at 550; *First Cent. Fin. Corp.*, 238 B.R. at 16-17. *But see Adelphia Communications*, 285 B.R. at 597-99 (recognizing that a debtor-corporation named under a D&O Policy may also have an interest in the proceeds).

147. "Because corporations pay for and own insurance policies, courts considering the question have concluded that the policies are property of the estate pursuant to 11 U.S.C. § 541(a)(1)." *First Cent. Fin. Corp.*, 238 B.R. at 15-16 (citing A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1001 (4th Cir. 1986) ("Under the weight of authority, insurance contracts have been said to be embraced in this statutory definition of 'property.'")); *accord* MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 92 (2d Cir. 1988); *La. World Exposition*, 832 F.2d at 1399; Minoco Group of Cos. v. First State Underwriters Agency of New

the *proceeds* of a D&O Policy generally do not become property of the estate because the debtor is not the named beneficiary under the policy and, thus, has no rights to the proceeds. As a result, they are available to satisfy the claims of tort victims asserted against the debtor's insiders.

The debtor owns any policy it purchased pre-petition; however, the debtor owns the proceeds of a D&O Policy only if the debtor is a named beneficiary.[148] Although the debtor-corporation is technically a named beneficiary under a D&O Policy containing Indemnity Coverage, a majority of courts have found that the proceeds of these policies are not included in the debtor's estate and, thus, are available to satisfy the claims of tort victims against insiders.[149] These courts reason that D&O Policies are different than ordinary liability insurance policies because, although the corporation purchases the policy, the insiders are the intended beneficiaries and ultimate recipients of the proceeds.[150]

In recent years, some corporations have purchased D&O Policies that also provide Entity Coverage for violations of securities laws.[151] The purpose of insuring the corporation along with its insiders is to avoid allocation of liability battles between insurance companies and corporations.[152]

> Entity coverage developed in response to difficult "allocation of loss" fights between insureds and insurers when securities claims were asserted against both insureds (directors and officers) and non-insureds (corporations) in the same suit (as well as covered and uncovered claims). Disputes ensued over allocating both litigation expenses and settlements or judgments between insured and uninsured co-defendants. In apportioning settlement or judgment responsibility, insurers claimed that a large portion of the total loss should be allocated to the corporation itself and, therefore, uninsured. Conversely, corporations argued that most of the loss should be allocated to the directors and officers and, therefore, insured.[153]

England Reinsurance Corp. (*In re* Minoco Group of Cos.), 799 F.2d 517, 519 (9th Cir. 1986); *In re* Davis, 730 F.2d 176, 184 (5th Cir. 1984); *Adelphia Communications*, 285 B.R. at 591; *Cybermedica*, 280 B.R. at 16; *Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. at 551.

148. *See* cases cited *supra* note 147.

149. *See, e.g., Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. at 550-51 ("'Unlike an ordinary liability insurance policy, in which a corporate purchaser obtains primary protection from lawsuits, a corporation does not enjoy direct coverage under a D & O policy.'" (quoting *First Cent. Fin. Corp.*, 238 B.R. at 16)). *But see Boston Reg'l Med. Ctr.*, 285 B.R. at 92 & n.5 (stating that a debtor, who is the named beneficiary of Indemnity Coverage under a D&O Policy, has an interest in the proceeds that is distinct from that of the insiders).

150. *See, e.g., Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. at 550.

151. Nan Roberts Eitel, *Now You Have It, Now You Don't: Directors' and Officers' Insurance After a Corporate Bankruptcy*, 46 LOY. L. REV. 585, 588-89 (2000) ("The addition of entity coverage is a relatively recent phenomenon in the D&O insurance market arising in the last five to six years.").

152. *Id.* at 589.

153. *Id.* (footnotes omitted).

Once the corporation is added to the policy, the insurer no longer can point its finger at the company, hoping to decrease the amount it must pay to the insiders under a D&O Policy.[154] Because the debtor has a property interest in the proceeds, that interest is included in the debtor's bankruptcy estate (i.e., the debtor possesses a contingent interest in receiving the policy proceeds).[155] Thus, any nondebtor beneficiary of the policy must request that the bankruptcy court grant relief from the automatic stay to access the proceeds.[156] In many cases, however, bankruptcy courts have granted either total or limited relief from the stay to co-beneficiary insiders wishing to access D&O Policy proceeds.[157]

Generally, insiders will be able to access the D&O Policy's proceeds should a plaintiff bring suit (if the suit is covered under the terms of the policy) against the insiders.[158] Thus, provided that tort victims can

154. *See id.* ("By insuring the corporation itself, the industry sought to avoid... allocation disputes."). As a result, however, some bankruptcy courts have determined that Entity Coverage causes the debtor-corporation to possess a property interest in the proceeds. *See, e.g.*, Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (*In re* Adelphia Communications Corp.), 285 B.R. 580, 593 (Bankr. S.D.N.Y. 2002); *In re* Cybermedica, Inc. 280 B.R. 12, 17 (Bankr. D. Mass. 2002); Circle K Corp. v. Marks (*In re* Circle K Corp.), 121 B.R. 257, 261 (Bankr. D. Ariz. 1990); *see also* Eitel, *supra* note 151, at 590 ("[T]here is a strong possibility that in the event of corporate bankruptcy, some or all of the policy proceeds will be deemed estate property. If so, the directors and officers could look only to the insolvent corporation for indemnification, and their claims, if allowed, would likely be subordinated . . . ."); *cf. First Cent. Fin. Corp.*, 238 B.R. at 17-18 (holding that proceeds of a D&O Policy were not property of the estate under its specific set of facts, but suggesting that proceeds of a policy containing Entity Coverage may be property of the estate).

155. *See* 11 U.S.C. § 541(a)(1) (2000) ("[The] estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case."); *see also* United States v. Whiting Pools, Inc., 462 U.S. 198, 204-05 (1983) (stating that property of the estate as defined under § 541(a)(1) is intended to be construed broadly); Affiliated Computer Sys. v. Sherman (*In re* Kemp), 52 F.3d 546, 550 (5th Cir. 1995) ("The conditional, future, speculative, or equitable nature of an interest does not prevent it from being property of the bankruptcy estate.").

156. *Compare* 11 U.S.C. § 362(a)(3) (placing an automatic stay over "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate"), *with* § 362(d)(1) (stating that, after notice and a hearing, a court shall grant relief from a stay if a party in interest has shown "cause, including the lack of adequate protection of an interest in property of such party in interest").

157. *See, e.g.*, *Adelphia Communications*, 285 B.R. at 599-600 (ordering limited relief from the automatic stay, thereby allowing insiders to access the D&O Policy proceeds up to a certain amount); *Cybermedica*, 280 B.R. at 20 (granting the insiders' motion for relief from the stay to use the proceeds for reasonable litigation expenses).

158. The insiders need not seek relief from a stay under § 362(a) to access insurance proceeds of the typical D&O Policy—even if the policy should contain Indemnity Coverage. *But see* Houston v. Edgeworth (*In re* Edgeworth), 993 F.2d 51, 56 n.21 (5th Cir. 1993) ("Once a court has determined that an insurance policy is property of the estate, 11 U.S.C. § 362 should

successfully assert their claims against the insiders, these victims will have a source of repayment other than the personal assets of the insiders. Consequently, insider access ensures that the interests of both the tort victims and the insiders are protected, as the proceeds will not be distributed pro rata as property of the debtor's estate.

2. Postpetition D&O Policies

A debtor also may elect to purchase a D&O Policy after the petition date. If so, the premiums paid by the estate to the insurer would be an administrative expense as one of the "actual, necessary costs and expenses of preserving the estate . . . rendered after the commencement of the case."[159] Like a pre-petition D&O Policy, a postpetition D&O Policy is also property of the debtor's estate.[160] However, insiders named as beneficiaries under postpetition D&O Policies may access the proceeds directly without petitioning the bankruptcy court for relief from the automatic stay, regardless of whether the debtor is named as a co-beneficiary under the policy.[161] Nonetheless, a corporate debtor may have difficulty acquiring a new D&O Policy or may be forced to pay premiums well over the market rate because of its financial situation.[162] Further, in the tort setting, postpetition policies are unlikely to provide coverage for pre-petition injuries, making them of little interest to tort victims, except to fund payments on postpetition claims.

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stay any injured party from suing or recovering from the debtor's insurer."); Executive Risk Indem., Inc. v. Boston Reg'l Med. Ctr., Inc. (*In re* Boston Reg'l Med. Ctr., Inc.), 285 B.R. 87, 91-92, 94 (Bankr. D. Mass. 2002) (requiring insiders to obtain relief from the stay because the debtor had a property interest in the proceeds by virtue of the Indemnity Coverage contained in the D&O Policy). However, if the D&O Policy contains Entity Coverage, the insiders most likely must request that the bankruptcy court grant relief from the automatic stay because the debtor has an interest in the policy proceeds. *See supra* notes 151-56 and accompanying text.

159. 11 U.S.C. § 503(b)(1)(A).

160. *See* 11 U.S.C. § 541(a)(7).

161. Section 541(a) states that property of the estate includes only the debtor's *interests* in property. Thus, the § 362(a) automatic stay does not apply to the proceeds of a D&O Policy acquired postpetition until the debtor has an interest in those proceeds. *Cf.* Ochs v. Lipson (*In re* First Cent. Fin. Corp.), 238 B.R. 9, 21-22 (Bankr. E.D.N.Y. 1999) (holding that co-insured insiders may access the proceeds of a D&O Policy acquired pre-petition without petitioning the bankruptcy court for relief from the stay because the debtor had no interest in the proceeds absent the presence of a claim against the debtor).

162. *See, e.g.*, *Adelphia Communications*, 285 B.R. at 592 (noting that one of the debtors in that case was unable to purchase a new D&O Policy); *see also* Jon D. Schneider, *D&O Insurance: Will It Be Available After a Chapter 11 Filing?*, at 3-4 (Dec. 11, 2002) (discussing the application process for acquiring a D&O policy), *at* http://www.goodwinprocter.com/publications/ins_schneider_12 _11_02.pdf.

IV. CONCLUSION

Tort damages (and whether or not they are collected) can thus be impacted by bankruptcy on a variety of levels and in a number of ways. The savvy tort lawyer will understand the potential for defendants to use the Bankruptcy Code to avoid or delay payment of the tort claim and will incorporate this understanding into her evaluation and strategy of the case and any potential settlement.