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3rd Circ. Ruling Gives 363 Asset Purchasers More Security

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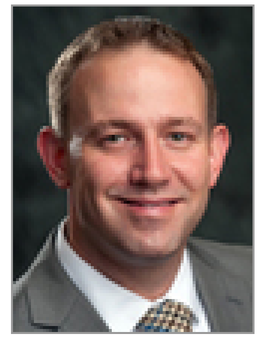
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In In re Emoral Inc., 740 F.3d 875 (3d Cir. 2014), the United States Court of Appeals for the Third Circuit determined whether personal injury causes of action could be asserted by individual claimants against a third party on a state law "mere continuation" theory of successor liability, or if such causes of action were "generalized" in nature and property of the debtor's estate. The Court of Appeals found that such causes of action were property of the debtor's estate, thus prohibiting individual claimants from seeking restitution from the nondebtor party.

In August of 2010, Emoral Inc., a manufacturer of diacetyl, a chemical used in food flavoring, sold certain of its assets and liabilities to Aaroma Holdings LLC, formerly known as Duane Street LLC. The asset purchase agreement accompanying the sale specifically stated that Aaroma was not assuming any of Emoral's liabilities arising from personal injuries sustained from exposure to diacetyl, a product Emoral had manufactured and sold until 2006.

Subsequent to the asset sale to Aaroma, Emoral filed for Chapter 7 bankruptcy protection in the United States Bankruptcy Court for the District of New Jersey.

Emoral's Chapter 7 trustee asserted that the asset sale constituted a fraudulent transfer, leading to the execution of a settlement agreement whereby Aaroma agreed, among other things, to pay $500,000 to Emoral's bankruptcy estate in exchange for a release from any "causes of action ... that are property of [Emoral's] estate."

Certain claimants alleging injury from exposure to diacetyl while working at plants that used the product for food flavoring or as consumers of the product objected to the release language in the settlement agreement to the extent that it might bar the diacetyl plaintiffs from bringing claims against Aaroma, as successor to Emoral, for personal injuries related to diacetyl.

In response to the diacetyl plaintiffs' objection, the parties agreed that Aaroma was not released from claims not belonging to Emoral's Chapter 7 estate. Following bankruptcy court approval of the settlement agreement, the diacetyl plaintiffs filed state court complaints against Aaroma alleging personal injury and product liability claims, and asserting that Aaroma was a "mere continuation" of Emoral and, therefore, liable. Aaroma then moved the bankruptcy court to compel dismissal of the actions because they were barred by the release language in the settlement agreement.

The bankruptcy court denied Aaroma's motion, holding that the personal injury causes of action were not property of Emoral's Chapter 7 estate, and, thus, the settlement agreement's release language did not apply. The bankruptcy court held, inter alia, that the injuries alleged by the diacetyl plaintiffs were particular and individual in nature rather than a generalized injury suffered by all of Emoral's creditors.

The bankruptcy court found that the underlying injury precipitating the state court actions was harm personal to the diacetyl plaintiffs. Therefore, such causes of action were not property of Emoral's estate and were properly commenced by the diacetyl plaintiffs.

Aaroma appealed to the United States District Court for the District of New Jersey, which reversed the bankruptcy court's decision, finding that the diacetyl plaintiff's claims were general in nature, the resolution of which would inure to the benefit of all of Emoral's creditors rather than solely to the diacetyl plaintiffs. Appeal to the Third Circuit followed. In a majority decision, the Third Circuit affirmed the holding of the district court.

The Third Circuit began its analysis by stating the general rule that creditors lack standing to assert claims that are property of a debtor's estate. Further, in order for such a claim to be estate property, it must not arise from the legal or equitable interests of just one creditor or discrete group of creditors.

Additionally, the court noted that under New York and New Jersey law,[1] a buyer is not liable for the debts and liabilities of the seller unless one of several exceptions to that general rule applies. One of the exceptions is for a buyer that is a "mere continuation" of the seller. This exception is urged by the diacetyl plaintiffs.

In affirming the district court, the Third Circuit examined the differences between the personal injury causes of action asserted by the diacetyl plaintiffs and the "mere continuation" theory of successor liability under which those causes of action were brought. The diacetyl plaintiffs did not, and in fact could not, assert that their personal injury claims were a result of Aaroma's direct wrongful conduct. Rather, the only theory of liability under which Aaroma could be held accountable is that it was a "mere continuation" of Emoral.

A cause of action asserting successor liability against a third party necessarily arises from underlying damage or injury that can properly be defined as personal or individual to the specific claimant. However, the diacetyl plaintiffs' causes of action against Aaroma were based not upon personal injury, but successor liability, which is grounded on facts generally available to all of Emoral's creditors, and any recovery realized as a result would increase the pool of assets available to all creditors in general rather than to the diacetyl plaintiffs particularly.

A successful cause of action asserted against Aaroma based on a "mere continuation" theory of successor liability would effectively render Aaroma liable for the entirety of Emoral's liabilities rather than just those arising from injuries related to Emoral's use of diacetyl. Therefore, the diacetyl plaintiffs' causes of action against Aaroma were generalized, rather than individual to any one claimant, and are properly brought by the Chapter 7 trustee as property of Emoral's estate.

In support of its decision, the court referenced a bankruptcy court decision from the District of New Jersey for the proposition that successor liability claims are property of a debtor's estate and, therefore, properly asserted by the trustee. Specifically, the court cited In re Keene Corp., 164 B.R. 844 (Bankr. S.D.N.Y. 1994), a 1994 decision in which the United States Bankruptcy Court for the Southern District of New York held that asbestos claimants could not proceed against a third-party defendant on a successor liability cause of action, as such claims belonged to the debtor's estate.

Additionally, the court likened such claims to those for alter ego veil piercing, which In re Buildings by Jamie Inc., 230 B.R. 36, 43 (Bankr.D.N.J.1998), held are also property of a debtor's estate. As those claims too would benefit a debtor's estate as a whole, the causes of action were similar in that they are properly characterized as general rather than individual claims and are property of a debtor's estate.[2]

The dissent disagreed with the majority's separation of the personal injury claims from those for successor liability against Aaroma, asserting that the two were so inextricably tied such that the claims in their entirety were individualized to the diacetyl plaintiffs and were not properly characterized as property of Emoral's estate.

It is important to note that they did not allege the so-called product line exception that under the laws of some states gives rise to successorship liability. That exception was not available because Aaroma did not continue to manufacture or sell diacetyl. The court's conclusion might well have been different if the claims had been based on that theory, because that theory is available only to persons injured by the product.

The Third Circuit's holding in Emoral has important implications in the context of asset sales under 11 U.S.C. § 363. If the sale is appropriately structured, entities purchasing a distressed debtor's assets through the bankruptcy process would have greater protections against the subsequent claims of those seeking to hold the purchaser liable for damages arising from the debtor's presale conduct. Courts applying Emoral's successor liability analysis to 363 sales will allow asset purchasers greater security from later liability, and ensure orderly disposition of a debtor's assets.

On Feb. 7, 2014, the diacetyl plaintiffs filed a petition for rehearing before the original panel and the Third Circuit en banc. The Third Circuit directed Aaroma to file an answer to the diacetyl plaintiffs' petition on or before March 7, 2014. The petition is supported by three amicus curiae briefs filed by Dan Schechter, professor of law at Loyola Law School, the American Association for Justice and the New Jersey Association for Justice.

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[1] There was no dispute as to whether New York or New Jersey law applied, but as the relevant legal standards for both states were identical, there was no need for a choice of law analysis.

[2] There are cases on both sides of this issue.
