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Private Credit Lenders – Navigating Successor Liability Issues

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The primary investment thesis of a private credit lender is simple — get the loan repaid at maturity. Private credit lenders do not make loans as a means to acquire their borrower's business. There are circumstances, however, where private credit lenders must be prepared to take ownership when the borrower is distressed and there is no realistic prospect of near-term loan repayment. Becoming the owner of a borrower's business may very well be the loan recovery option of last resort.

There are different ways to implement a change of control or debt for equity restructuring, including an out-of-court conversion, a foreclosure sale under article 9 of the Uniform Commercial Code ("Article 9 Sale") and a Section 363 sale under chapter 11 of the Bankruptcy Code (a "Bankruptcy Sale"). Which strategic path to pursue depends on a host of factors, including cost, speed, degree of consensus, extent of operational distress and need to address other liabilities on the borrower's balance sheet.

In either an Article 9 Sale or Bankruptcy Sale, secured lenders are entitled to "credit bid" for their collateral using debt forgiveness as the purchase price to acquire the collateral. Credit bidding lenders can thus acquire the collateral comprising a borrower's business without making major changes to the enterprise and will assume those specific liabilities that are necessary to operate the business. Credit bidding lenders typically form a new acquisition vehicle ("NewCo") that will look very similar to the borrower. NewCo is likely to conduct the same operations from the same locations, serving the same customers with the same employees. NewCo may even conduct its business using the same name as the former borrower.

Outside of bankruptcy, a scenario like this may expose NewCo to unpaid claims from the borrower's creditors based upon so-called "successor liability" theories. The borrower's unpaid creditors may contend that NewCo is a "mere continuation" of the borrower/seller and that NewCo should be liable for the debts of the seller.[1] Lenders considering "out-of-court" strategies, including an Article 9 Sale, will certainly prefer the speed and cost of this option. In certain circumstances, however, the specter of potential successor liability can outweigh the advantages of an Article 9 Sale. The risk of successor liability is greater when the sale is marked by evidence of wrongful or unfair acts, such as when the buyer knows that the seller will transfer the sale proceeds to the seller's shareholders and leave the seller's creditors unpaid.

The Bankruptcy Code, under section 363(f), allows property sales "free and clear of *interests* in such property" provided that certain conditions are met. The Bankruptcy Code, however, does not define the term "interest." As a result, courts have had to determine what "interests" can be expunged by a free and clear sale under section 363. While the term certainly includes a property interest in the asset itself (like a lien or mortgage), many courts (including the Second, Third and Fourth Circuit Courts of Appeals) have adopted a broad interpretation that considers "interests" to include obligations that are connected to, or arise from, the property being sold. Under this view, "interests" includes successor liability claims.[2] Thus, in a credit bid acquisition via a Bankruptcy Sale, all creditor claims – even debts that are contingent and unliquidated – can be cut off through a court order. The practical value of this strategy was recently reinforced as the purchaser of Sears' assets in a Bankruptcy Sale sought to use the sale order to enjoin a products liability claimant from asserting successor liability claims.

In 2019, substantially all of Sears' assets were purchased under section 363 of the Bankruptcy Code. One year later, a consumer allegedly injured in a dryer accident brought a products liability action in Illinois state court against the manufacturer (Electrolux), the seller (a Sears debtor), and an affiliate of the buyer, Transform SR Brands LLC. The state court permitted discovery against Transform, who then asked the Bankruptcy Court to enjoin such claims based on the order approving the 363 sale. Transform, it argued, could not be a defendant because the Court's 2019 sale order expressly provided that Sears' assets were sold free and clear of successor liability claims. Indeed, the sale order specifically held that the sale would not subject the buyer to successor liability, finding that the buyer was not a successor to the debtors and that the buyer would not have purchased the assets but for such relief. The motion to enforce the sale order is now pending before the Southern District of New York Bankruptcy Court.

Proskauer's Private Credit Restructuring team works with clients to formulate and execute simple and complex loan recovery strategies both in and out of court. Maximizing speed and minimizing cost are priorities for every lender-side debt restructuring, but there is no one-size-fits-all solution, particularly for change of control transactions involving a complex business. Contingent and unliquidated exposure for product defects, environmental contamination, labor and employment matters and long term contractual commitments can render an out-of-court solution infeasible. As illustrated by the recent skirmish in Sears, a carefully structured and well executed acquisition via credit bid in bankruptcy may be the best path to ensure that the acquisition vehicle will be protected from all claims and liabilities, including successor liability. We will continue to follow the developments in Sears and update our clients as the situation unfolds.

[1] Whether an entity is considered a "mere continuation" of the seller is a matter of state law. The court in *Call Ctr. Techs., Inc. v. Grand Adventures Tour & Travel Pub. Corp.*, 635 F.3d 48, 53 (2d Cir. 2011) ("Interline"), applying Connecticut law, considered two theories to determine whether a purchaser is a "mere continuation" of the seller: "continuity of ownership" and "continuity of enterprise." Under the "continuity of ownership" theory, courts evaluate whether there is an identity "of stock, stockholders and directors between" the buyer and seller. *See Chamlink Corp. v. Meritt Extruder Corp.*, 899 A.2d 90 (Conn. App. Ct. 2006). Under the "continuity of enterprise" theory, courts evaluate whether the "'successor maintains the same business, with the same employees doing the same jobs, under the same supervisors, working conditions, and production processes, and produces the same products for the same customers.'" *Interline*, 635 F.3d at 53 (quoting *Kendall v. Amster*, 948 F.2d 1041, 1051 (Conn. App. Ct. 2008)).

[2] *See, e.g.*, *In re Chrysler LLC*, 576 F.3d 108, 119–27 (2d Cir. 2009), *vacated as moot sub nom. Ind. State Police Pension Trust v. Chrysler LLC*, 558 U.S. 1087 (2009), *appeal dismissed as moot In re Chrysler LLC*, 592 F.3d 370 (2d Cir. 2010) (affirming asset sale to newly formed acquisition entity free and clear of debtor's liability for certain vehicle defects); *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003) (affirming asset sale free and clear of employment discrimination claims); *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996) (affirming asset sale free and clear of successor liability under Coal Industry Retiree Health Benefit Act of 1992). While not squarely addressing the scope of "interests" under Section 363(f), the Seventh Circuit arguably adopted a more narrow approach when it permitted a successor liability action under ERISA to proceed against a secured creditor's newly formed acquisition entity after it obtained stay relief to foreclose on its collateral in the bankruptcy case. *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 51 (7th Cir. 1995) (a "second chance [of recovery] is precisely the point of successor liability, and it is not clear why an intervening bankruptcy proceeding, in particular, should have a *per se* preclusive effect on the creditor's chances."). The U.S. Supreme Court has yet to weigh in on this issue.

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